IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

JOHN J. WALLACE, individually and on behalf of all others similarly situated, Plaintiff,	
v.	CIVIL ACTION NO. 95-CV-6303
SYSTEMS & COMPUTER TECHNOLOGY CORPORATION, MICHAEL J. EMMI, MICHAEL D. CHAMBERLAIN, and ERIC HASKELL, Defendants.	

Memorandum

McGlynn, J. **September , 1997**

In this securities action, John J. Wallace alleges on behalf of a class of investors that defendant Systems & Computer Technology Corporation and three of its executive officers (collectively, "SCT" or "defendants") violated §§ 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C.A. §§ 78j(b), 78t(a) ("1934 Act"), Securities and Exchange Commission ("SEC") Rule 10b-5, 17 C.F.R. 240.10b-5, and committed negligent misrepresentation under Pennsylvania law[1]. Before the Court is the

[1] The individual defendants are" (1) Michael J. Emmi, President, Chief Executive Officer, and Chairman of the Board of Directors; (2) Michael Chamberlain, Senior Vice-President, President of SCT Software Group, and Director; and (3) Eric Haskell, Treasurer, Chief Financial Officer, and Senior Vice President of Finance and Administration. I will collectively refer to the corporate defendant, Systems & Computer Technology Corporation, and the individual defendants as "SCT" or "defendants".

defendants' Motion to Dismiss the plaintiff's Second Amended Complaint pursuant to Fed. R. Civ. P. 12(b)(6) for failure to state a claim and pursuant to Fed. R. Civ. P. 9(b) for failure to plead scienter with the required specificity. This court has subject matter jurisdiction pursuant to 15 U.S.C. § 78aa, 28 U.S.C. § 1331, and 28 U.S.C. § 1367. For the reasons set forth herein, defendants' Motion will be **Granted** in part and **Denied** in part.

I. Procedural History

On October 4, 1995 the plaintiff filed a complaint in this matter.[2] Defendants moved to dismiss the complaint for failure to state a claim on November 13, 1995. Plaintiffs amended the complaint as a matter of right on November 28, 1995, and the defendant's motion to dismiss was denied by order dated December 8, 1995.[3] On December 12, 1995, defendant moved to dismiss plaintiff's amended complaint. The motion was granted in part and

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[2] Accordingly, the Private Securities Litigation Reform Act of 1995 ("Act"), which was enacted on December 22, 1995, has no application to this action. Although SCT argues that the Act applies to various claims asserted in the Second Amended Complaint, Section 108 of the Act expressly provides that the Act does not apply to actions commenced before, and pending on, the date of the enactment of the Act. P.L. 104-67, § 108, 109 Stat. 737, 758 (1995). Rule 15(c) permits relation back where the claim asserted in the amended pleading arose out of the conduct, transaction or occurrence set forth in the original.

[3] Plaintiffs were granted leave to amend pursuant to Fed.R.Civ.P. 15, which provides that, "a party may amend the party's pleading once as a matter of course at any time before a responsive pleading is served." The Third Circuit has held that a plaintiff may file an amended complaint without leave of court or by written consent of the adverse party even after a motion to dismiss is filed, as that motion does not constitute a "responsive pleading". Kelly v. Delaware River joint Comm'n., 187 F.2d 93, 94 (3d Cir., cert. denied, 342 U.S. 812 (1951).

denied in part by order dated April 19, 1996.[4] This court sua sponte granted the plaintiffs leave to amend the amended complaint "if [they could] supplement [their] allegations with more detailed information about [defendant's] alleged involvement with the analyst reports." Wallace, 1996 WL 195382 at *13.

Plaintiffs filed a Second Amended Complaint (SAC) on November 28, 1995 in which they apparently abandoned the allegations regarding the two analyst reports and assert various new allegations which were not contained in the amended complaint. Plaintiffs have not formally sought leave to amend. The defendants filed this motion to dismiss the SAC on February 18, 1997.

II. The Allegations in the Second Amended Complaint

The Second Amended Complaint ("SAC") alleges the following facts which I accept as true for purposes of this motion. This action is brought by John J. Wallace who seeks to represent a class of shareholders (collectively "plaintiffs") who purchased SCT securities at an artificially inflated price between June 15, 1995

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[4] In granting SCT's motion in part, this court concluded that (1) SCT's statements regarding the Adage acquisition could not be construed as material predictions of immediate financial improvement; (2) plaintiffs have not adequately pleaded facts that evidence SCT's responsibility for and control over statements in two analyst reports; (3) the failure to forecast was not actionable because SCT had no duty to forecast declines in EPS and income for its fiscal year 1995 fourth quarter; and (4) SCT adequately disclosed the "trend" of increased costs in its SEC filings. Wallace v. Systems & Computer Technology, 1996 WL 195382 at *13-14 (E.D. Pa. 1996).

This court also denied the motion, in part, concluding that Wallace stated a claim for SCT's alleged failure to make adequate disclosures regarding known future increases in employee costs and other expenses as required by Item 303 of Regulation S-K in its Form 10-Q for the third quarter of fiscal 1995. Id.

and October 2, 1995 ("the class period"). SAC ¶ 1. SCT and its officers inflated the market price of SCT stock before and during the class period by issuing misleading positive statements while concealing certain adverse facts regarding (1) the existence of defects in SCT's software product for the utilities market and the increased costs and decreased revenues associated therewith (2) the likelihood that Adage, a newly-acquired subsidiary operating in the manufacturing and distribution market, would be a "drag on earnings or be unprofitable" and (3) anticipated cost increases in the fourth quarter 1995 and anticipated fourth quarter earnings per share. Once SCT revealed it true financial condition on October 2, 1995, the price of SCT stock deflated and investors suffered damages. Id at ¶ 4.

SCT is a publicly-traded corporation that provides computing management services and administrative application software in the higher education, government, cable/telecommunications, manufacturing/distribution, and utilities markets. Id. ¶¶ 8, 14, 22. Individual defendants Michael J. Emmi, Michael D. Chamberlain, and Eric Haskell served as officers and directors of SCT. Id. ¶ 9. SCT's fiscal year runs from October 1 to September 30. The third quarter of fiscal year 1995 ran from April 1, 1995 to June 30 and the fourth quarter from July 1 to September 30, 1995. In fiscal year 1995, SCT achieved revenues of $176,148, a Net Income of $3,058, and a Fully Diluted Net Income Per Share of $.21, as compared to revenues of $148,214, a Net Income of $11,646, and a Fully Diluted Net Income Per Share of $.83 for fiscal 1994. DX-H at

14 (Annual Report Form 10-K for fiscal 1995).

As a publicly traded company, SCT is required to file with the SEC reports on Form 10-Q for each of the first three quarters of the fiscal year and a report on Form 10-K for the fourth quarter and year-end results. Each quarter, SCT also held a conference call in which institutional investors, investment professionals and any other interested person participated or monitored the discussion.[5] Id. ¶ 19. Securities analysts disseminated the information provided by the defendants during these conference calls to the investing public. Id. at 20.

In mid-1990, SCT entered the market for utilities software sales, service, and maintenance. Since that time, SCT has successfully enhanced its presence in the utilities market through acquisitions and by developing and improving its software systems. Id. ¶¶ 25-26. In December 1992, SCT introduced a new software package for this market.

Before and during the class period, defendants issued positive statements about the utilities business and its software while concealing adverse facts known by the third quarter that rendered their statements materially misleading.[6] Specifically, SCT had knowledge of the following facts by May 15, 1995. As a result of

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[5] Each quarter, shortly before the conference call was to be held, SCT issued a press release announcing its quarterly earnings as well as the date, time, subject matter, and phone number of the conference call. These calls served as SCT's principle method of dissemination of material information to the market about SCT's business and financial performance. Id.

[6] These statements will be identified later in this opinion.

reports by customers, the company knew that the software, already licensed to and installed at customer sites, had developed "extensive and severe defects." Id. ¶ 31. Often, SCT was contractually obligated to repair the software pursuant to maintenance and support agreements with many of those customers.[7] Id. 31-32. As result of reports of malfunctions by customers, the company's analysis of the cause of the defects in the software, and its unsuccessful efforts to correct the same, SCT knew that the "problem was so serious that nearly a complete redesign of the software was necessary" requiring months of work and substantial expense.[8] Id. at ¶ 32. In a January 1996 conference call, SCT "admitted" having knowledge that none of the utilities that had purchased the defective product would recommend the software to other potential utilities customers. Id. ¶ 33. Because software purchases by utilities are based on recommendations by current users, sales of the product completely ceased at the beginning of the class period for a period of approximately one year.[9] Id. SCT

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[7] As disclosed after the class period in Form 10-K for fiscal 1995 filed on December 19, 1996, such costs for a single utility customer amounted to $1,000,000. ¶ 33. At the end of 1996 the problems with this customer were still not corrected but management believed the $400,000 remaining reserve was adequate. ¶ 33.

[8] This redesign took approximately one year to complete. Id.

[9] "Here, defendants belatedly admitted, in January, 1996, that their inability to procure favorable recommendations of their utilities software from any existing customers had left SCT unable to sell its utilities software to any customers since about the beginning of the class period. Obviously this dearth of sales (and revenues) had been apparent to the defendants while it was occurring, when defendants were talking publicly about a

incurred expenses before and during the class period for ongoing redesign efforts and for repairs. Id. As known by SCT, a substantial amount of the cost of developing new products would be included in reported expenses and reduce reported income rather than capitalized as SCT reported in its second quarter Form 10-Q. ¶ 41. SCT chose not to disclose the defects in the utilities software or the financial impact thereof until October 2, 1995.

By early 1995, SCT was actively seeking to expand into a new market: manufacturing and distribution. In May, 1995, SCT executed a definitive agreement to purchase Adage Systems International, Inc. ("Adage"), a vendor of software for the manufacturing and distribution industries.[10] Id. ¶¶ 22-24, 37. The acquisition was announced on June 5, 1995. Id. During a July 17, 1995 conference call regarding SCT's third quarter, SCT impliedly represented that "Adage would not be a drag on earnings (i.e., would not be unprofitable)." ¶ 43(c). By July 17, 1995, SCT's fourth quarter, the company had increased employee expenses by hiring additional personnel to sell and support the newly acquired software. Id. ¶ 37. Because Adage's business was "characterized by long lead times for customer order placement," unless the selling process commenced

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strategically implemented slowing of the sales process." Pl's. Mem. in Opp. to Def's. Mot. to Dis. at p. 24.

[10] SCT announced that it had signed a letter of intent to purchase Adage on February 8, 1995. Adage had developed an enterprise resource planning system to address sales, engineering, procurement, manufacturing, finance, and other functions for the manufacturing and distribution industries. Id. at ¶¶22-24.

months in advance of the end of a quarter, SCT knew it was improbable that an order would be placed during that quarter. Id. By July 17, 1995, SCT had added numerous employees for Adage and could accurately estimate Adage expenses in the fourth quarter. Thus, by July 17, 1995, as a result of the visibility of Adage's revenues for the fourth quarter and the actual and planned level of expenses, defendants knew or recklessly disregarded the fact that Adage would suffer a "material loss" in the fourth quarter. Id. ¶¶ 37. Adage suffered a pre-tax loss in the fourth quarter of $940,000, $.04 cents per share. ¶¶ 37, 51. SCT chose not to disclose this fact until October 2, 1995.

By mid-July 1995, SCT anticipated and had deliberately incurred increases in employee costs; research and product development costs; and selling and administrative costs in the fourth quarter all of which increased expenses in the fourth quarter by approximately $3 million. SCT then failed to disclose these "planned" expenses in its Form 10-Q for the third quarter of the 1995 fiscal year, and did not disclose them at any other time during the class period. ¶ 38.

On July 17, 1995, SCT issued a press release announcing that third quarter results increased from $.21 per share in the third quarter of 1994 to $.27 per share in the third quarter of 1995. Defendant Emmi stated that, "in the third quarter of fiscal 1995, SCT was proud to achieve record earnings before the charge for purchased R&D." Then, during the third quarter conference call with investment professionals on or about July 17, 1995, defendants

Emmi and Haskell "projected earnings per share for the fourth quarter of almost $.34 cents per share, an increase from the recently reported third quarter of fiscal 1995 and the fourth quarter of the previous year of $.27." Id. ¶ 43. At the time the defendants made these positive statements, they knew or recklessly disregarded adverse information rendering these statements materially misleading.[11]

The dispute in this case arises from the timing of SCT's announcement of the adverse information, as well as the possible motives underlying the company's timing.

On July 26-27, 1995, Emmi and Haskell each sold 10,000 shares of their own SCT stock at approximately $26 per share, yielding proceeds of approximately $500,000. Id. ¶ 56. The price drop between October 2, 1995 the day of the announcement that allegedly caused a correction in the stock price to reflect SCT's true financial state, and October 3, 1995 - was approximately $8.

[11] Specifically, plaintiffs claim that knowledge of the following information undermines a reasonable basis in this prediction: First, that the defects in the utilities software would lead to both lost revenues and increased costs. SCT would lose revenues from the sale of licenses for that software and costs would increase due to the need for a costly redesign of the product and the company's obligation to repair the software pursuant to maintenance agreements with customers. Second, by mid-July, SCT anticipated increases in employee costs and research and development costs. ¶¶ 31-33, 38, 40-41. Third, by mid-July SCT knew that Adage was likely to suffer a material loss in the fourth quarter as revealed by actual and planned level of expenses and "improbability that an order would be placed during the quarter" in view of the characteristically long lead times for order placement by customers of Adage ¶¶ 37-38. It was inevitable that income and earnings per share in the fourth quarter 1995 would decline from the previous quarter and the fourth quarter of fiscal 1994. ¶¶ 41-42.

Assuming that the price drop was due entirely to the correction of the allegedly false information, Emmi and Haskell's trading gains would each amount to approximately $80,000.

On October 2, 1995, SCT announced estimated earnings per share of $.08 to $.12 cents for the fourth quarter of fiscal 1995 by press release compared to $.27 in fourth quarter of the previous year. Id. ¶ 49, ¶ 51. SCT attributed this decrease in earnings primarily to increased costs relating to the Adage acquisition and product development for its utility business. Id. On October 3, SCT's stock price dropped 25% from the previous day's closing price of $27 per share to $19 5\8, approximately $8 dollars. Id. ¶ 50.

On October 25, 1995, SCT announced its actual results for the fourth quarter and for fiscal year 1995. Contrary to SCT's July 17 predictions, fourth quarter earnings per share for the 1995 fiscal year were $.10 cents as compared to $.27 cents in the fourth quarter of the previous year. Although revenues for the fourth quarter increased to $47 million in 1995 from $41 million in 1994, expenses increased almost $10 million, causing a $62% drop in net income compared to the prior year. Pl's Mem. Opp. Def. Mot. Dism. at 7; SAC ¶ 51. Plaintiff's claim that only after the class period, in a January 2, 1996 conference call, did defendants adequately disclose the problems with its utility software, the increased costs associated therewith, as well as the increased costs associated with the acquisition of Adage, its new manufacturing and distribution business. Furthermore, SCT's utility business lost money in the 1995 fiscal year. SCT explained

that the shortfall in earnings resulted from a slippage in software license fees during the quarter, and from greater than expected expenditures in Adage, as well as in its utility business.

In sum, the SAC alleges that SCT:

> (1) made various statements "touting" the utilities software but failed to disclose the existence of and financial impact of known serious design flaws in the software for the utilities market; that sales of the software had "ceased" and this decline in sales was not caused by a voluntary strategic decision but by the refusal of existing customers to recommend the software; and that the defects could not be corrected within the fourth quarter;
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> (2) failed to disclose that expenses were rising and product development costs were increasingly being expensed rather than capitalized[12];
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> (3) predicted that the newly-acquired subsidiary, Adage, would not be a drag on earnings even though SCT knew by mid-July,1995, that Adage would suffer a material loss in the fourth quarter ending September 30, 1995[13]; and

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[12] In their amended complaint plaintiffs alleged that SCT reported that product development costs for SCT's utilities business would be capitalized although SCT expected to expense "substantial amounts" of these costs. Nonetheless, SCT did not reveal that these expenses would reduce SCT's income and earnings per share for the fourth quarter of fiscal 1995 as compared to the third quarter of fiscal 1995 and the fourth quarter of fiscal 1994. By order dated April 19, 1996, this court dismissed this claim finding that, based on the facts and statements quoted in the complaint, SCT did not have a duty to forecast a decrease in income and EPS in the fourth quarter. Wallace v. Systems & Computer Technology Corp., 1996 WL 195382 at *20 (E.D. Pa. 1996). As discussed later in this opinion, plaintiffs quote new statements in the SAC that allegedly trigger a duty to disclose this information.

[13] To the extent plaintiffs attempt to re-allege that SCT's disclosures imply that Adage "could increase the company's income almost immediately", the SAC is dismissed on futility grounds. This court dismissed this claim without leave to amend by order dated April 19, 1996. Wallace, 1996 WL 195382 at *13. Later in this opinion, I will discuss plaintiffs related allegation that

finally,

(4) issued a fourth quarter earnings per share projection of $.34 cents that lacked a reasonable basis.

Defendants now move to dismiss the Second Amended Complaint.

III. Standard of Review under 12(b)(6)

A motion to dismiss under Federal Rule of Civil Procedure 12(b)(6) is one of limited inquiry, focusing not on "whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." Scheuer v. Rhodes, 416 U.S. 232, 236 (1974). In considering a motion to dismiss under 12(b)(6), the court must accept all the factual allegations contained in the complaint as true and give the plaintiffs the benefit of every inference reasonably drawn therefrom. In re Donald Trump Casino Sec. Litig., 7 F.3d 357, 366 (3d Cir. 1993), cert. denied, 114 S. Ct. 1219 (1994); Columbia Natural Resources, Inc v. Tatum, 58 F.3d 1101, 1109 (6th Cir. 1995) ("The district court may not grant a Rule 12(b)(6) motion based on disbelief of factual allegations in the complaint"). A complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that "the facts alleged in the complaint, even if true, fail to support the claim." Ransom v. Marrazzo, 848 F.2d 398, 401 (3d Cir. 1988); Conley v. Gibson, 355 U.S. 41, 45-46 (1957)(court may grant the motion only if certain that, according to the facts alleged in the complaint, plaintiffs cannot recover on

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SCT represented that Adage would not be unprofitable and thereby triggered a duty to disclose anticipated fourth quarter losses. SAC ¶2.

any viable theory). Dismissal can be based on the lack of a cognizable legal theory or the absence of sufficient facts alleged under a cognizable legal theory. Balistreri v. Pacifica Police Department, 901 F.2d 696, 699 (9th Cir. 1990). Because a 12(b)(6) motion tests the sufficiency of the allegations of the complaint, the plaintiff is "required to `set forth sufficient information to outline the elements of his claim or to permit inferences to be drawn that these elements exist'". Kost v. Kozakiewicz, 1 F.3d 176, 183 (3d Cir. 1993)(quoting 5A Wright & Miller, § 1357 at 340 (2d Ed. 1990). The court need not accept as true conclusory allegations of law, conclusions unsupported by the facts alleged and unwarranted inferences. Flanagan v. Shivley, 783 F. Supp. 922, 927 (M.D. Pa. 1992), aff'd, 980 F.2d 722 (3d Cir. 1992), cert. denied, 510 U.S. 829 (1993).

A. Preliminary Issue-Attachments

Defendants have attached eight exhibits (A-H) to the memorandum of law supporting their motion. The documents submitted include copies of SCT's public filings with the SEC, a transcript of a quarterly teleconference held with securities analysts, and an analyst report. Generally, a district court may not consider any material beyond the pleadings in ruling on a Rule 12(b)(6) motion. However, the Third Circuit has made clear that, in determining a motion to dismiss, a court may properly refer to the factual allegations contained in the complaint, exhibits attached thereto, documents referenced therein, matters of public record, and undisputedly authentic documents attached as exhibits to the

defendant's motion to dismiss if the plaintiffs' claims are based on those documents.[14] Pension Benefit Guaranty Corp. v. White Consol. Indus., 998 F.2d 1192, 1196 (3d Cir. 1993), cert. denied, 114 S. Ct. 687 (1994).[15] If a district court wishes to consider additional material, Rule 12(b) requires that the motion be treated as one for summary judgment under Rule 56, giving the party opposing the motion notice and an opportunity to conduct necessary discovery and to submit pertinent material addressing the extraneous materials. Fed. R. Civ. P. 12(b); J/H Real Estate Inc. v. Abramson, 901 F. Supp. 952, 955 (E.D. Pa. 1995); Goldman v. Belden, 754 F.2d 1059, 1056-66 (2d Cir. 1985). Exhibit A is an unauthenticated transcript of a July 1995 teleconference. Plaintiffs do not dispute the authenticity of this document. Thus, if the claims are based on this document, it can be considered in deciding this motion to dismiss. Plaintiffs have specifically referred to and quoted statements made during this conference in the complaint. SAC at ¶ 39. Therefore, plaintiff's claims are clearly "based on" those documents and they may properly be

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[14] A district court may take judicial notice of the contents of relevant public disclosure documents required by law to be filed, and actually filed, with the SEC as facts "capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned." Kramer v. Time Warner Inc., 937 F.2d 767, 773 (2d Cir. 1991); Fed. R. Civ. P. 201(b)(2).

[15] Accord In re Donald Trump Casino Sec. Litig., 7 F.3d 357, 368 n.9 (3d Cir. 1993), cert. denied, 510 U.S. 1178 (1994); Pache v. Wallace, Civ.A.No. 93-5164, 1995 WL 118457 at 2, aff'd, 72 F.3d 123 (3d Cir. 1995); Kramer v. Time Warner, Inc., 937 F.2d 767, 773 (2d Cir. 1991); J/H Real Estate Inc. v. Abramson, 901 F. Supp. 952, 955 (E.D. Pa. 1995).

considered. Moreover, plaintiffs do not argue that I may not refer to this document. Instead, plaintiffs state in their response to defendants motion that, "defendants apparently concede--as they must--that defendants' statements during this conference call constitute public statements that are actionable if they are fraudulent." Pl's Mot. Opp. 20-21 n.5, 25.

Exhibits C-H are reports that SCT filed with the SEC; thus, they are public records of which I may take judicial notice, See Fed. R. Evid. 201, without converting the motion to dismiss into one for summary judgment. Moreover, these documents come within the guidelines established by the Third Circuit - i.e., there is no dispute as to authenticity and plaintiffs' complaint is "based on" these documents. Plaintiffs specifically refer to each of the documents (Exhibits A, C-H) in the SAC and do not dispute their authenticity.[16] Plaintiffs further allege that defendants committed fraud on the market by failing to disclose certain information,

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[16] SCT's exhibits A and C-H and the paragraphs of the second amended complaint that refer to them are identified below:
Exibit A - Transcript of SCT's third quarter earnings conference call July 1995. SCT also submitted a sound recording the conference call held on July 1995 in support of its motion. (SAC ¶ 39);
Exhibit C - SCT's first quarter 1995 (ended Dec. 31, 1994)Form 10-Q. (SAC ¶29);
Exhibit D - SCT's second quarter 1995 Form 10-Q. (SAC ¶34);
Exhibit E - SCT's third quarter 1995 Form 10-Q(SAC ¶¶ 35, 46);
Exhibit F & G - SCT's 1994 Annual Report Form 10-K. (SAC ¶ 26);
Exhibit H - SCT's 1995 Fourth quarter and Annual Report Form 10K. (SAC ¶ 51).
SCT's exhibit B, dated July 18, 1995, is an Unterburg Harris earnings update on SCT's third quarter. The document is not referred to in the second amended complaint. Because this document is not incorporated by reference in the complaint, the court will not consider the exhibit in determining this motion.

thereby driving up the market price of SCT stock. The claim, therefore, boils down to what disclosures were and were not made to the market. In fact, defendants allege that these exhibits contain some of the very same information that plaintiffs specifically claim defendants omitted. Were I to refrain from considering these documents, complaints that allege fraud due to material omissions during a class period would survive a motion to dismiss "even though they would be doomed to failure" because the alleged omissions were actually disclosed to the market. Kramer v. Time Warner, Inc., 937 F.2d 767, 774 (2d Cir. 1991). Foreclosing resort to such documents might lead to complaints filed solely to extract nuisance settlements." Id. Consequently, I will make reference to exhibits C-H in ruling on their motion.

The remaining exhibit B, an analyst report that was neither relied on nor attached to plaintiff's complaint, falls outside the narrow limitations imposed by the Third Circuit in Pension Benefit. Accordingly, I will not consider the contents of Exhibit B in determining this motion.

Finally, SCT has attached five SCT press releases to its reply to plaintiffs' opposition papers as exhibits.[17] These releases are not public records. Pension Benefit, 998 F.2d at 1196 (listing as public records: criminal case dispositions, letter decisions of government agencies, and published reports of administrative

[17] The documents are identified as follows: SCT press release dated 2/8/95; SCT press release dated 4/18/95 (SAC ¶ 30); SCT press release dated 5/15/95; SCT press release dated 6/5/95; SCT press release dated 7/13/95.

bodies). The authenticity of each release is undisputed. However, only one of the press releases has been incorporated by reference into plaintiffs' second amended complaint. Accordingly, I will consider only the one release that meets the Pension criteria. But see Pache, 1995 WL 118457, *1.

Accordingly, I find that all but five (four press releases and an analyst report) of defendants' submissions may be considered as part of the motion to dismiss and that doing so will help to secure the just, speedy, and least expensive determination of this action. See Fed. R. Civ. P. 1.

IV. DISCUSSION

Defendants seek dismissal of the Second Amended Complaint ("SAC") on several grounds: (1) pursuant to Fed. R. Civ. P. 41 for failure to comply with the order granting leave to amend[18]; (2)

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[18] Defendants move to dismiss the SAC pursuant to Rule 41(b) for failure to comply with this court's order dated April 19, 1996 or for failure to prosecute with reasonable diligence. The order granted plaintiffs leave to amend "if they can supplement their allegations with more detailed information with more detailed information about SCT's alleged involvement with the analyst reports". Ten months later, on November 28, 1995, plaintiffs filed the SAC in which they apparently abandoned the allegations regarding the analyst reports and asserted various new allegations not contained in the first amended complaint. Involuntary dismissal under this rule is the most severe sanction that the court may apply, and it should be used only in extreme situations. Poulis v. State Farm Fire and Casualty Co., 747 F.2d 863, 866 (3d Cir. 1984) (dismissal is a drastic sanction and should be reserved for those cases where there is a "clear record of delay or contumacious conduct by the plaintiff"). Although plaintiffs waited 10 months before filing the SAC, the order granting leave to amend set no timetable for this submission. In this regard, the orders involved in the cases on which defendants rely are distinguishable from the one at bar. See, Ferdik v. Bonzelet, 963 F.2d 1258 (9th Cir. 1992) (affirming district courts' dismissal of complaint for failure to comply with

pursuant to Fed. R. Civ. P. 15 for prejudice arising from undue delay and futility; (3) pursuant to 12(b)(6) for failure to state a claim for securities fraud; (4) pursuant to Fed.R.Civ.P. 9(b) for failure to allege facts sufficient to establish scienter with specificity; (5) for failure to plead an underlying substantive violation of the federal securities laws necessary to sustain a claim for "controlling person" liability under §20(a) of the Act.

A. Fed. R. Civ. P. 15(a) Leave to Amend

The plaintiffs have submitted the SAC as a proposed amendment to the Amended complaint. Pursuant to Rule 15(a), a party may amend the party's pleading once as a matter of course at any time before a responsive pleading is served. Once an amendment is filed as of right, a "party may amend the party's pleading only by leave of court or by written consent of the adverse party; and leave

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district courts' order requiring plaintiffs to file an amended complaint "by August 19, 1988" and warning that "failure to file complaint in a timely manner would result in dismissal without further notice"); Chapin Group v. Perpetual Savings Bank, 1990 WL 171216 (E.D. Pa. 1990)(order required that plaintiff's response be filed "no later than October 8, 1990"). Furthermore, this courts' April 19 order only clearly and unequivocally denied plaintiffs leave to amend "to perpetuate the claim that SCT's press releases and SEC filings predicted immediate financial benefits in the fourth quarter of 1995" because "it would be futile-such vague and unsupported statements would not assume any actual significance to a reasonable investor." Wallace, 1996 WL 195382 at *13. I conclude that dismissal of the SAC pursuant to Rule 41(b) is inappropriate at this time. To the extent that plaintiffs have repled any claim I have previously dismissed, amendment will be denied on futility grounds under Rule 15.

I note that this is not a case in which a party has assumed an obstructionist posture. Defendants have not pointed to evidence that plaintiffs have a history or "clear record" of dilatoriness nor have they alleged any specific or actual prejudice to their defense resulting from the instant delay.

shall be freely given when justice so requires." In the instant case, plaintiffs amended the complaint once as of right on November 28, 1995. Leave of the court was required to amend the complaint thereafter. I dismissed the November 28 complaint by order dated April 19, 1996 and sua sponte granted plaintiffs leave to amend. Because the allegations in the proffered SAC appear to exceed the scope of that order, it is necessary to evaluate the propriety of granting plaintiffs leave to amend to assert those allegations which exceed the scope of the order.[19] Generally, an amendment which does not conform to Rule 15(a) is "without legal effect and any new matter it contains will not be considered unless the amendment is re-submitted for the court's approval. Straub v. Desa Indus., Inc., 88 F.R.D. 6, 8 (M.D. Pa. 1980). Nevertheless, "some courts have held that an untimely amended pleading served without judicial permission may be considered as properly introduced when leave to amend would have been granted had it been sought, and when it does not appear that any of the parties will be prejudiced by allowing the change." Id. Leave to amend a pleading is to be

[19] The order granting leave to amend stated that, "this court will allow [plaintiffs] to file a second amended complaint if [they] can supplement [their] allegations with more detailed information about SCT's alleged involvement with the analyst reports." On November 28, 1995, ten months later, plaintiffs filed the SAC in which they assert various new factual allegations of misleading statements or omissions regarding defendants software for the utilities market, anticipated losses in the fourth quarter for SCT's newly aquired subsidiary, Adage, SCT's earnings forecast for that quarter and a new claim for negligent misrepresentation. Def. Mot. at 7. Plaintiffs also reiterate their claim regarding planned cost increases, particularly employee costs, which reduced profits and profit margins in the fourth quarter.

"freely given when justice so requires." Rule 15(a). From its inception, Rule 15 has been given a liberal interpretation by the federal courts. See 6 Wright & Miller, Federal Practice and Procedure: Civil § 1471, §1486 (1971). While Rule 15[a] has been interpreted to give the court extensive discretion to decide whether to grant leave to amend and to impose conditions on the allowance of a proposed amendment, Id., this discretion is not absolute. A refusal of a motion for leave to amend must be justified.[20] Foman v. Davis, 371 U.S. 178, 181-82 (1962). Permissible justifications include: (1) undue delay; (2) bad faith or dilatory motive; (3) prejudice to the opposition; (4) repeated failures to correct deficiencies with previous amendments; and (5) futility. Id.; Arab African Int'l Bank v. Epstein, 10 F.3d 168, 174 (3d Cir. 1993). The Third Circuit court of appeals has stated that "prejudice to the nonmoving party is the touchstone for the denial of an amendment." Lorenz v. CSX Copr., 1 F.3d 1406, 1414 (3d Cir. 1993). In the instant case, defendants assert two reasons why this court should deny the proposed amendment: prejudice and futility.[21] Def's Mot. to Dis. at 9.

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[20] In Foman v. Davis, 371 U.S. 178, 181-82 (1962), the Supreme Court interpreted the phrase "freely-given" as a limit on a district court's discretion to deny leave to amend. The Court stated, "the Federal Rules reject the approach that pleading is game of skill in which one misstep by counsel may be decisive to the outcome" and that "the purpose of pleading is to facilitate a proper decision on the merits." Id. at 182.

[21] Defendants also contend that plaintiffs have simply re-asserted previously dismissed claims regarding misstatements about SCT's newly acquired subsidiary, Adage. Def. Mot. at 7. I conclude, however, that this claim is not merely a reformulation

I find that allowing the proposed amendment, filed 10 months after plaintiffs were granted leave to amend, will not result in prejudice to the plaintiffs. Prejudice has been defined as "undue difficulty in prosecuting [or defending] a lawsuit as a result of a change in tactics or theories on the part of the other party." Deakyne v. Comm'rs of Lewes, 416 F.2d 290, 300 (3d Cir. 1969); Schuylkill Skyport Inn, Inc. v. Rich, 1996 WL 502280, *3 (E.D. Pa. 1996). The non-moving party must do more than merely claim prejudice. Bechtel v. Robinson, 886 F.2d 644, 652 (3d Cir. 1989). It "must show that it was unfairly disadvantaged or deprived of the opportunity to present facts or evidence which it would have offered had the . . . amendment been timely." Id.; Schyulkill, at *3. Further, the mere passage of time, without more, does not require that a motion for leave to amend be denied; however, at some point, the delay will become undue, placing an unwarranted burden on the opposing party. Adams V. Gould, 739 F.2d 858, 868 (3d Cir. 1984), cert. denied, 469 U.S. 1122 (1985). In the case at hand, defendants claim that they have been prejudiced because "individuals with information relevant to this litigation have left SCT's employ, memories of important witnesses may have faded, and the claim has become generally stale." Def's. Mot. to Dismiss at 9. Such conclusory allegations do not sufficiently demonstrate prejudice to defendants warranting denial of leave to amend the complaint.

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of the claim contained in the Amended Complaint.

Furthermore, while plaintiffs have exceeded the scope of this court's order granting leave to amend, the changes in the SAC are not substantial. Although plaintiffs have added some new allegations, they are closely related to the allegations in the first amended complaint and the general theories of recovery remain the same. To the extent there are significant differences between the first and second amended complaints, defendants have not been deprived of an opportunity to respond to the new allegations. The defendants have already filed briefs in response to the SAC addressing the merits of the claims contained therein. These submissions have been given full consideration by the court in its disposition of the instant motion. Accordingly, this court finds no unfair disadvantage to defendants from allowing the SAC.

I next examine whether the proposed amendment would be futile. Amendment of a complaint is futile if the amended complaint fails to state a cause of action because it would not survive a motion to dismiss. Adams, 739 F.2d at 864; Riley v. Taylor, 62 F.3d 86, 92 (3d Cir. 1995); J.E. Mamiye & Sons, Inc. v. Fidelity Bank, 813 F.2d 610, 613 (3d Cir. 1987); Lorenz v. CSX Corp., 1 F.3d 1406, 1414 (3d Cir. 1993) (plaintiffs denied leave to amend where facts sought to be pleaded were repetitious of those already contained in the complaint and even if pleaded were insufficient to state a claim). I will therefore examine the sufficiency of the SAC according to the standard set forth under Rule 12(b)(6).

B. Federal Securities Claim: Section 10b and Rule 10b-5

Plaintiffs assert claims under Section 10(b) and 20(a) of the

Securities Exchange Act, 15 U.S.C. §§78j(b), 78(t)(a), and Rule 10b-5 promulgated thereunder. 17 C.F.R. §240.10b-5.

Section 10(b) provides a broad prohibition on the use of "manipulative and deceptive devices" in connection with the purchase or sale of a security.[22] Pursuant to its authority under section 10(b), the Securities and Exchange Commission issued Rule 10b-5 which prohibits material misrepresentations and omissions in connection with the purchase or sale of a security.[23] Rule 10b-5 has been interpreted to establish an implied private right of action. See Blue Chips Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971). To state a claim under Rule 10b-5, a plaintiff

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[22] Section 10 provides:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--...(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or
contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. §78j(b).

[23] The rule states:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality...
(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
17 C.F.R. § 240.10b-5.

must allege "that the defendant (1) made a misstatement or omissions of material fact; (2) with scienter; (3) in connection with the purchase or sale of securities; (4) upon which plaintiffs relied; and (5) that plaintiffs' reliance was the proximate cause of their injury." See In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1417 (3d Cir. 1997)(citing In re Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1243 (3d Cir. 1989). If plaintiffs have failed to allege one of these elements, their complaint must be dismissed. Finally, since the claim being asserted is a "fraud" claim, plaintiff must satisfy the heightened pleading requirements of Federal Rule of Civil Procedure 9(b).[24] Id. The defendants do not challenge the sufficiency plaintiff's allegations regarding the reliance, causation, or damage elements of the cause of action and neither party disputes that the instant case occurred in connection with the sale of securities that are covered by §10b and Rule 10b-5.[25] Therefore, the focus of my inquiry is whether the complaint

[24] Rule 9(b) provides that "in all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Rule 9(b) also provides that "malice, intent, knowledge, and other condition of mind of a person may be averred generally."

[25] Plaintiffs assert a fraud on the market theory and, therefore, no individual reliance need be proven. The fraud on the market theory is based on the hypothesis that, in an open and developed market, the price of a company's stock is determined by the available material information regarding the company and its business. Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir 1986); In re Apple Computers Litig., 886 F.2d 1109, 1114 (9th Cir. 1989), cert. denied, 496 U.S. 943 (9th Cir. 1989). Thus, where a defendant has made a material misrepresentation, the court will presume that the misrepresentation occasioned an increase in the stock's value that induced the plaintiff's to purchase the stock. Id. at 1161. This presumption operates also, however, to offset

adequately alleges that defendants made materially misleading misstatements or omissions with scienter. I will examine each of these elements in turn.

Misstatements or Omissions of Material Facts

A statement is false or misleading if it is factually inaccurate, or additional information is required to clarify it. Pache, 1995 WL 118457, at *3. Misrepresentative statements of fact clearly satisfy this requirement. In addition, misleading statements of subjective analysis or extrapolation, such as opinions, motives or intentions, or forward looking statements, such as projections, estimates, and forecasts may be actionable if the speaker does not genuinely and reasonably believe them when made. In re Donald Trump Sec. Lit., 7 F.3d at 368. An omission can also satisfy this element where silence would make other statements misleading or false. However, the mere possession and nondisclosure of material facts does not impose liability under Rule 10b-5. See e.g., Basic v. Levinson, 485 U.S. 224, 239 n.17 (1988)("silence absent a duty to disclose is not misleading"); First Virginia Bankshares v. Benson, 559 F.2d 1307, 1317 (5th Cir.

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optimistic forecasts, so if in a prior or simultaneous document, the market is warned about certain risks, these warnings are presumed also to have been incorporated into the stock price. Raab v. General Physics Corp., 4 F.3d 286, 289 (4th Cir. 1993); See also, Kriendler, 877 F. Supp. at 1150 n.8. ("According to the efficient market hypothesis, the market is an open and developed one which immediately impounds all available information, even knowledge that is difficult to articulate and obtain and plaintiffs are charged with knowledge of all available information; they may not myopically focus. . . on a lie and ignore the truthful information already available to the market.")

1977)(Rule 10b-5 creates a statutory duty to "speak the full truth when defendant undertakes to say anything"); Pache 1995 WL 118457, at *3. There is no duty to disclose general economic conditions because the federal securities laws do not compel disclosure of the obvious. In re Donald Trump Casino, 7 F.3d at 377; Krim v. Banctexas Group, Inc., 989 F.2d 1435, 1446 (5th Cir. 1993)(compliance with securities laws requires issuers to disclose material firm-specific information regarding predictions but information concerning general economic facts and conditions is presumed to be known to investors and analysts). In sum, a statement is potentially actionable if, when read in light of all the information then available to the market or a failure to disclose particular information, it conveyed a false or misleading impression. In addition, certain vague and general statements of optimism have been held not actionable as a matter of law because they constitute no more than "puffery" and are understood by the reasonable investors as such. San Leandro Emergency Medical Group Profit Sharing Plan v. Phillip Morris Cos. Inc., 75 F.3d 801, 810-11 (2d Cir. 1996).

A misleading statement or omission is material if there is a "substantial likelihood" that the reasonable investor would have viewed the statement or omission "as having significantly altered the 'total mix' of information made available." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). In other words, a misrepresentation or omission is material if it is substantially likely that it would have assumed actual significance to a

reasonable investor contemplating the purchase of securities. In re Craftmatic Sec. Litig., 890 F.2d at 639. Although materiality is a mixed question of law and fact ordinarily decided by the trier of fact, if the alleged misrepresentations and omissions are so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality, the court may rule that the allegations are not actionable as a matter of law. Trump, 7 F.3d at 369 n.13 (quoting Shapiro v. UJB Fin. Corp., 964 F.2d 272, 280 n.11 (3d Cir.), cert. denied, 113 F. Ct. 365 (1992)). When assessing materiality, the court should not only consider the statement or omission itself, see e.g., Hoxworth v. Blinder Robinson & Co., 903 F.2d 186, 200-01 (3d Cir. 1990)(extremely exaggerated or vague statements constitute immaterial puffing), but also the context in which it occurs. See Trump, 7 F.3d at 364 (recognizing "that a statement or omission must be considered in context, so that accompanying statements may render it immaterial as a matter of law"); San Leandro Emergency Medical Group Profit Sharing Plan v. Phillip Morris Cos. Inc., 75 F.3d 801, 810-11 (2d Cir. 1996). The "bespeaks caution" doctrine under federal securities law provides that sufficient cautionary language, caveats, or warnings render estimates or predictions of business results immaterial as a matter of law. The Third Circuit Court of Appeals in In re Donald Trump Casino Sec. Lit., 7 F.3d 357 (1993) explicitly adopted the doctrine.[26] The doctrine can be invoked only

[26] Although the instant case involves the fraud on the market theory and in that way differs from Trump, there is ample

for misleading "forward-looking" statments, not misleading statements of existing fact. In such cases, the statements' potential to mislead is offset by some other disclosure. In Trump, the Third Circuit described the doctrine as follows

> "when an offering documents' forecasts, opinions, or projections are accompanied by meaningful cautionary statements, the forward looking statements will not form the basis for a securities fraud claim if those statements did not affect the "total mix" of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law. Trump, 7 F.3d at 371-72.

In order for a court to conclude that cautionary statements render the misrepresentations and omissions immaterial as a matter of law, a defendant must establish that the cautionary statements "discredit the other one so obviously that the risk of real deception drops to nil." Virginia Bancshares, Inc. v. Sandburg, 501 U.S. 1083 (1991). The cautionary statements must be substantive and tailored to the specific future projections, estimates, or opinions which plaintiffs challenge." Trump, 7 F.3d at 371-72. "Disclaimers must relate directly to that on which investors claim to have relied." Kline v. First Western Sec. Lit., 24 F.3d 480, 489 (3d Cir.), cert. denied, - U.S._ 115 S. Ct.613 (1994). On the

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authority that the "bespeaks caution doctrine" is applicable. See, e.g. Gary v. Wallace 1995 wl 118457 (E.D. Pa. 1995) Sinay v. Lamson & Sessions co., 948 F.2d 1037 (6th Cir. 1991); Polin v. conductron Corp., 552 F.2d 797, 806 ,.28 (9th Cir.), cert. denied, 434 U.S. 857 (1977); In re Goodyear Tire and Rubber, 1993 U.S.Dist. LEXIS 5333 (E.D. Pa. Apr. 21, 1993)(Dubois, J.); 49 BUS.Law 481, 483 (1994)(nothing in doctrinal logic of "bespeaks caution" doctrine limits application to exclude fraud on market cases).

other hand, a "vague or blanket disclaimer which merely warns the reader that the investment has risks will be inadequate to prevent misinformation. A claim will be dismissed under the bespeaks caution doctrine only when the documents containing defendants' challenged statements contain enough cautionary language or disclosure that "a reasonable fact finder could not conclude" that the alleged misrepresentation "would influence a reasonable investors investment decision." Trump, 7 F.3d at 369. When applying the doctrine to a truth on the market case, the context in which the statement must be read should include prior or simultaneous documents. Pache 1995 WL 118457 at *4 ("Optimistic forecasts in one document are not actionable if the market was sufficiently warned in a prior or simultaneous document that those forecasts might not be fulfilled."). However, when the cautionary statements are scattered about in different places, it may be harder to conclude as a matter of law that they had cautionary effect. Virginia, 502 U.S. 1097. Thus, there can be no liability under the securities laws, as a matter of law, where meaningful and specific cautionary disclosures are made regarding the subject matter of the alleged misrepresentation.

As noted, plaintiffs rely on the fraud on the market theory in bringing this action. An essential corollary to this theory is a "truth on the market" defense recognizing that a statement is materially misleading only if the allegedly undisclosed facts have not already entered the market. In re Convergent Tech. Sec. Litig., 948 F.2d 507, 513 (9th Cir. 1991)). If the market has become aware

of the allegedly concealed information, the facts allegedly omitted by the defendant would already be reflected in the stock's price and the market would not be misled. In re Glenfed, Inc. 42 F.3d 1541 (9th Cir. 1994)(citing, In re Apple Computer Sec. Litig., 886 F.2d 1109, 1114); See also, In re Goodyear, 1993 WL at *4 n.6 (in fraud on the market case the market is presumed to have absorbed all material information respecting a company and its business). However, before the "truth on the market" defense can be applied, the defendants must prove that the information that was allegedly withheld or misrepresented was transmitted to the public with a degree of intensity and credibility sufficient to effectively counterbalance any misleading impression created by the defendant's statements. Apple at 1492-93 (citing, Kaplan v. Rose, 49 F.3d 1363, 1376 (9th Cir. 1994). A truth on the market defense can thus be granted on a motion to dismiss where the company's SEC filings or other documents disclose the very information necessary to make their public statements not misleading. See, In re Stac Electronics Sec. Litig., 89 F.3d 1399, 1410 (9th Cir. 1996) (affirming dismissal of fraud on the market claim because the prospectus disclosed some of the alleged omitted information, and the rest would have been obvious to the market even without disclosure), cert. denied, -U.S.-, 117 S.Ct. 1105. Guided by these standards, the court will evaluate each of plaintiff's claims.

(1) Software for the Utilities Market

Defendants argue that the plaintiffs have not stated a claim for securities fraud based on the statements alleged in the

complaint because they (1) are not actionable misstatements because either the statements themselves are not sufficiently factual to support liability or they do not trigger a duty to disclose the information allegedly omitted; (2) are immaterial or not misleading as a matter of law because the information allegedly omitted was disclosed before or during the class period or (3) merely allege fraud by hindsight.[27] This court agrees.

Plaintiffs attempt to establish scienter for this claim by alleging insider trading plus the fact that in January 1996 SCT admitted that the problems it experienced with its utilities software were "so serious and extensive that none of the Company's utilities customers would recommend [SCT's] utilities software to potential purchasers." SAC at ¶ 33. Defendants claim that these allegations have not met the requirements for pleading scienter in Rule 9(b). This court agrees.

Plaintiffs cite the following representations as materially misleading:

(1) A document issued August 5, 1994 entitled, "SCT positioned for the '90's," states that SCT's utilities business, had

[27]In determining SCT's first motion to dismiss the amended complaint, I determined that because SCT had not pointed out any material statements regarding SCT's fourth quarter finances which disclosure of these costs would correct, the only breach of duty plaintiffs may claim is that imposed by Item 303(b). I dismissed plaintiffs' claims to the extent that they were based on failure to disclose cost increases because information about expenses, including product development costs, was adequately disclosed in SCT's quarterly SEC filings. Wallace v. Systems & Computer Technology, at p. 22-23.

"excellent new opportunities - domestic and international."

(2) A document issued December 23, 1994 stated that the utilities software, "Innovative BANNER Customer Information System", was "experiencing significant demand." Id. ¶ 45.

(3) SCT's 1994 Annual report Form 10-K filed on December 23, 1994 "touted" its utilities software,[28] stating

> We have experienced unprecedented growth-both internally and in the ever-expanding utilities marketplace-and we are proud to note that the BANNER Customer Information System (CIS) continues to be a leading comprehensive software system backing customer service strategies.

Id. at 26.[29]

(4) Form 10-Q for the first quarter of 1995 filed on February 14, 1995 and Form 10-Q for the second quarter filed on May 15, 1995 attributed reported increases in SCT's revenues in that quarter to "increases in licenses of BANNER and related services in both the United States and international utilities markets", the fact that SCT was developing new products for the utility market.

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[28] The 1994 fiscal year ended September 30, 1994.

[29] These statements and the context in which they were presented are as follows: We have experienced unprecedented growth both internally and in the ever-expanding utilities marketplace-and we are proud to note that the BANNER Customer Information System (CIS) continues to be a leading comprehensive software system backing customer service strategies." Because BANNER CIS can be tailored to meet a utility's specific needs, the utility is able to respond more rapidly to customers, to achieve more accuracy in customer billing and to gain greater control over its financial resources. Rule-based technology and fourth generation language combine to make BANNER CIS flexible and easy to use . . . From a marketing perspective, BANNER represents a solution that covers a broad portion of the utility industry, ranging from small and mid-size providers to those with a multi-million customer base. SCT Utility Systems also offers BANNER Utility Finance and Human Resources, giving the division a suite of products that ranks as one of the strongest, integrated administrative series for the utility user. In the next year, additional BANNER systems for utilities are expected to be introduced.
SAC ¶¶ 26, 31-36.

(5) SCT's first and second quarter Form 10-Q also stated that the "costs of such [new] products have been capitalized".[30] Id. ¶¶ 29, 34, 41, 46.

(6) During a conference call held on or about July 17, 1995, SCT stated that its utilities business was strong; and that,

(7) although the company was slowing the sales of its utilities software to improve the quality of that software,

(8) this improvement would be accomplished with a cleaner software release in the upcoming quarter. Id. ¶ 43; DX-A.

Plaintiffs allege that SCT knew information by May 15, 1995 that rendered these statements materially misleading. ¶¶ 35-36.

These statements allegedly (1) impliedly represent that the "slowing of sales" was the result of a deliberate and voluntary decision by the defendants to decelerate sales of a defective

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[30] Plaintiffs claim that Form 10-Q for the third quarter ended June 30, 1995 is misleading for failure to disclose that (1) expenses were sharply increasing due to the addition of hundreds of employees and costs associated with the extensive known defects of the Company's utilities software; (2) product development costs were increasingly being expensed rather than capitalized; (3) problems with SCT's existing products had brought sales of the existing software to a halt; and that (4) Adage was experiencing losses. SAC ¶ 46. Plaintiffs claim that SCT violated both Rule 10b-5 and Item 303(b), SEC Reg. S-K, 17 C.F.R. § 229.303(b) for failing to disclose the above in its third quarter Form 10-Q and for failing to disclose extensive defects in the utilities software and the likely effects thereof. Id. at ¶35, 46. Item 303(a), governing financial statements for full fiscal years, mandates disclosure of "known trends or uncertainties that the registrant reasonably expects will have a material . . . impact on net sales, revenues or income from continuing operations." 17 C.F.R. §229.303(a)(3)(ii). "If the registrant knows of events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in the relationship shall be disclosed. Id. Item 303(b), governing interim financial statements, requires that the registrant disclose any "material changes in those items specifically listed in paragraph (a). 17 C.F.R. §229.303(b).

product rather than the result of dissatisfied customers' refusal to recommend the product; (2) fail to disclose that sales had not merely "slowed" but had actually ceased by the beginning of the class period for approximately one year; (3) fail to disclose the existence of, financial impact, and severity of the defects: (i.e., that a nearly complete redesign of the product was necessary and that SCT was contractually obligated to bear the cost repair for customers); and (4) falsly represent that the improvement in the quality of the utilities software would be accomplished in the fourth quarter when SCT knew otherwise by June 1995.[31] SAC ¶ 32.

Plaintiffs also claim that the defendants failed to disclose the fact that (1) expenses were sharply increasing due to the addition of hundreds of employees and costs associated with the known defects of the Company's utilities software; and (2) product development costs were increasingly being expensed rather than capitalized.

I conclude that Statement 1, that the utilities software business "had excellent new opportunities - domestic and international" and Statement 3, that the utilities software "continues to be a leading comprehensive software system backing customer service strategies," do not support a cause of action

[31] As discussed later in this opinion, plaintiffs also claim that these facts (i.e. that demand for the product had stopped, SCT was incurring expenses in redesigning as well as repairing the software that had already been installed at customer sites constitute a "material change" or "known uncertainty or trend" that would reasonably be expected to have material impact on SCT's future revenues expenses and income under Item 303(b). SAC ¶ 33; Item 303(b), 17 C.F.R. §229.303(b).

under the securities laws. They are vague statements so devoid of concrete information that no reasonable investor would have relied on them. Shapiro v. UJB Financial Corp., 964 F.2d 272, 284 n.12 (3d Cir.)(expressions of general optimism constitute nothing more than puffing and are not actionable; forward looking statements that are wholly indistinct in time or in substance are immaterial), cert. denied, 506 U.S. 934 (1992); Lewis v. Chrysler Corp., 949 F.2d 644, 652-53 (3d Cir. 1991); Raab v. General Physics, 4 F.3d at 289 (vague statements cannot be the basis of a fraud claim as they were mere "puffing").

Statements 1-4 are not misleading as a matter of law. When plaintiffs allege that defendants knew of adverse circumstances which they failed to disclose or account for in making positive statements, the complaint must contain factual allegations that the adverse conditions existed at the time of the misstatement. Plaintiffs have not cited any contemporaneously existing information that should have been known to the defendants at the time the defendants made the challenged statements. Because the plaintiffs do not allege that defendants had knowledge of the defects in the utilities software or any other information inconsistant with the quoted representations until approximately May 15, 1995, any statements issued by defendants before that date can not be false or misleading. Accordingly, Statement 1 issued on August 5, 1994, Statement 2 issued on December 23, 1994, Statement 3 issued in December, 1994, and Statement 4 issued on February 14, 1995, can not support plaintiffs' claim for securities fraud.

Furthermore, defendants had no duty to update these statements. Under certain circumstances, when a corporation makes a public statement that is correct when issued, it has a duty to update that statement if it becomes materially misleading in light of subsequent events. Greenfield v. Heublein, Inc, 742 F.2d 751, 758 (3d Cir. 1984), cert. denied, 469 U.S. 1215 (1985). In Re Phillips Petroleum, 881 F.2d 1236, 1245 (3d Cir. 1989) (There is a duty to update prior statements if they were true when made, but will mislead if left unrevised in light of subsequent events). However, it is well settled that an accurate report of past successes does not contain an implicit representation that the trend is going to continue, and hence does not obligate the company to update the public as to the state of the quarter in progress. In Re Burlington Coat Factory Sec. Lit., 114 F.3d 1410, 1432 (3d Cir. 1997). Accordingly, there was no duty to update statements 1-4 in light of subsequently discovered information about the utilities product.

Contrary to plaintiffs' assertion, no reasonable investor would read Statement 8 as a definitive statement that the software would be corrected in the fourth quarter.[32] DX-A. Rather, the statement clearly indicates that SCT merely "hope[d]" that the problems could be identified, addressed, and resolved during the

[32] The actual statement made during the July, 1995 conference call is as follows. "Now this is not rocket science, it's, you know, human beings can do this work, so it'll get done and hopefully there will be a release this quarter of a much cleaner version of the software.¶ 43; DX-A at 7, 11

next quarter. DX-A at 7, 11 ("hopefully there will be a release this quarter of a much cleaner version of the software"). Projections of performance not worded as guarantees are generally not actionable under the securities laws. Raab v. General Physics Corp., 4 F.3d 286, 289 (4th Cir. 1993); Krim v. Banctexas Group,Inc., 989 F.2d 1435, 1446 (5th Cir. 1993). As a result, this statement is not actionable.

Statement 4 was reitereated on May 15, 1995. This statement, attributing the cause of reported increases in second quarter revenues to "increases in licenses of BANNER and related services in both the United States and international utilities markets", is also not misleading as a matter of law. Plaintiffs have failed to identify any information inconsistent with this statement that was available to defendants at the time this statement was issued. Knowledge of defects in the utilities software does not render a report of the products' past contribution to revenues false or misleading. No reasonable investor would read this as an implied prediction that the increases would continue.

Statement 5 is immaterial as a matter of law. Knowledge that product development costs would be "expensed" at the time stating that the "costs of [developing new products for the utility market] have been capitalized" (i.e. not included in reported expenses and reducing reported income) renders this statement false and misleading absent some other disclosure by SCT. ¶ 41. However, SCT's quarterly SEC reports do show a marked "trend" of increasing selling, general, and administrative (SG&A) costs. See, DX-E, (SG&A

expenses increased 22.62% from the previous third quarter and totaled $30,544,000 and $25,821,000 in the nine-month periods ending June 30, 1995 and 1994, respectively); DX-D (SG&A expenses increased 9.97% from the previous second quarter and totaled $20, 048,000 and $17,261,000 in the six-month periods ending March 31, 1995 and 1994, respectively); DX-C (SG&A expenses increased 23.3% from the previous first quarter and totaled $9,863,000 and $7,999,000 in the three month periods ending December 31, 1994 and 1993, respectively), as well as product development expenses not capitalized. See, DX-E Note E, (non-capitalized product development expenses totaled $7, 124, 000 and $5,643,000 in the nine month periods ending June 30, 1995 and 1994, respectively); DX-D, Note E, (such expenses totaled $4,369,000 and $3,890,000 in the six-month periods ending March 31, 1995 and 1994, respectively); DX-C, Note D,(such expenses totaled $2,283,000 and $1,900,000 in the three-month periods ending December 31, 1994 and 1995, respectively). The figures for a reasonable investors analysis and comparison were disclosed. Therefore, to the extent that plaintiffs allege that SCT failed to disclose such cost increases in violation of Rule 10b-5, that claim is dismissed.

Finally, statements 6 and 7, made during the July, 1995 conference call, are immaterial as a matter of law. These statements imply that the utilities business was "strong" and that the "company was [voluntarily] slowing sales of its utilities software to improve the quality of that software." SAC ¶ 43; DX-A

at 7, 11.[33] Plaintiffs claim that these statements are misleading because they fail to disclose that the software had "extensive and severe defects", that these defects led dissatisfied utilities customers to refuse to recommend the product to other utilities and that sales, therefore, completely ceased. These statements also failed to disclose that SCT was incurring costs of repairing products already sold to customers and in redesigning the software" and that by June, 1995, as a result of reported malfunctions and its own unsuccessful efforts to correct the problems, SCT knew or disregarded facts indicating that a complete redesign of the software was necessary. Pl's. Reply at 2-6; SAC ¶ 32-33.

My review of the disclosures made by SCT evidence that the market would not be misled by these statements or they were rendered immaterial because the market was aware of the potential effect of existing problems on revenue and profits not later than July 1995. See Shuster, 1997 Fed.Sec.L.Rep. ¶99, 437 at ¶99,867

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[33] The actual statements made during the July 1995 conference call are as follows. "As a result, we're slowing down the sales process ourselves to make certain that we don't, you know, slip this product into some customer and disappoint them and make certain we get it right. And it's unfortunate, but it happened, and, now, you know, you've got the rework cost so we're paying the cost of cleaning the damn thing up plus our own, I think, wise decision to slow the growth of the business down so that we can catch up on the product side and not have lousy products in customers' hands. So that's what's going on. Now this is not rocket science, it's, you know, human beings can do this work, so it'll get done and hopefully there will be a release this quarter of a much cleaner version of the software and we get back on track again, but we've been working on that one now for about 6 or 7 months, maybe even a little bit longer, a problem on that and I've sort of alerted you to the problem. DX-A.

(there can be no liability under the securities laws where meaningful and specific cautionary disclosures are made). Contrary to plaintiffs' assertion, SCT's disclosures were not limited to vague "sugar coated" statements about "delivery issues" and "quality issues" with the software. Pl's Resp. at 22.[34]

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[34] In the July 1995 conference call with securities analysts during which SCT made misstatements in connection with SCT's announcement of earnings for the third quarter, Emmi, the President, CEO, and Chairman of the Board of Directors, reported the following regarding the Utilities business:

> **Q.** Could you address the challenges that you're having in the utility business delivering product . . . ?
> **A.** Utilities have had delivery issues and that has slowed it down. But if you look at the utility sector as a whole, not just the software, three years ago we did $4 million, last year we did $15 million, this year we'll do $30 million. So while it's slowed, its still a strong performer and we've just got to get through some delivery issues there to even see higher growth, I think . . .
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> ***
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> . . . We've made management changes in the utilities business and a guy by the name of Bill Mahoney is now president of the utilities business. We've also changed the research and development vice president and Jack Kramer is now the R&D president of that business. These are strengthening moves. These are two of our strongest performers in the company and we think that they will get us back on track with the products side of the utilities business.

DX-A at 2-3.

> ****
>
> **Q**. And the utility business?
> **A**. (Mr Emmi): The utility business. We had a release of the product aimed principally at the electric utility market that was not as clean as we would have liked and we had quality issues in the release. So, we are working on cleaning up the quality of that release of the product to make certain that, you know, we don't disappoint customers. <u>As a result, we're slowing down the sales process ourselves to make certain that we don't, you know, slip this product into some customer and disappoint them and make certain we get it right. And it's unfortunate, but it happened, and, now, you know, you've got the rework cost so we're paying the</u>

cost of cleaning the damn thing up plus our own, I think, wise decision to slow the growth of the business down so that we can catch up on the product side and not have lousy products in customers' hands. So that's what's going on. Now this is not rocket science, it's, you know, human beings can do this work, so it'll get done and hopefully there will be a release this quarter of a much cleaner version of the software and we get back on track again, but we've been working on that one now for about 6 or 7 months, maybe even a little bit longer, a problem on that and I've sort of alerted you to the problem.

Q. And somewhat of an unfair question for you as a last one here. Is this problem basically exemplified by the Vice President of R&D change that took place in that business?

A. Emmi: Yes yes. We had put one of our people in who was, we thought quite capable. But the tasks are getting bigger and bigger for us in that business and that's good in that we're going to have a lot more product capability and a lot more growth than we ever thought. Believe me when I tell you this is a hot market and can be very good for us. The bad side to that is the level of complexity in the systems is growing and sort of grew past that individual's capabilities. We've not fired that person because it was just clear that we put somebody too green in the job. We have now probably our second most senior person in the company, technical person in the company on the job and the development staff, for example has gone from 15 to 50, and I could easily see the day were we have 150 developers in this market because of the demands of the market are so good. That says a lot of product, a lot of revenue growth is going to occur there, but you'd better get it right is our judgment. You'd better have the product quality stand tall. So we're taking the time to get quality back.

DX-A. at 5, 6-7.

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Q. Mike could you give us a feel for a 1996 outlook for your utility business, maybe hitting on the primary drivers of that area for that business, including the UK, electric, small utilities in the U.S. and services?

A. Emmi: Yeah it's hard for me not to get wildly enthusiastic, Dana. A bit of it hinges on getting the product stable . . . But, that's going to happen, I hope, shortly. So as that unfolds, it will make our selling, you know, we'll crank up selling again . . .

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Plaintiffs claim that defendants misstated the reason for declining sales. They assert that defendants had a duty to divulge that the reason "sales have slowed" is that no one would recommend the product, and that in the utility market, if the product is not recommended by another customer, no one will buy. I conclude that no reasonable investor would have considered this fact significant. Revealing that sales of an admittedly defective product are being deliberately retarded by a company communicates "the bottom line" to the purchaser of stock-they should not expect revenues from this area of the company's business in the immediate future. The fact

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> **Q.** Have you had any pieces of business in the UK that you thought you were the lock and where it didn't work out that way in recent times?
> **A**. Emmi: Yeah, there's been a couple where they decided to do nothing. They were electrics. To be honest, I guess that's not bad since we've had problems with that release of the software.

Id. at 12.

> In SCT's Annual Report for fiscal year 1994 on form 10-K filed prior to the class period, SCT disclosed that "[I]n addition to a license of the application software, clients also enter into a maintenance agreement with the company, usually for terms ranging from one to five years, which entitles the client to service and support . . . and functional and technical enhancements . . . The annual maintenance fee generally ranges from 10% to 15% of the license fee." DX-H at 3.

By these statements, SCT alleges that it disclosed, clearly and unequivocally, that it was experiencing problems with its software for the utilities industry; the company's decision, prompted by the stated desire to avoid disappointing customers, to slow the sales of that software; that it was incurring costs in connection with the reworking of its software; that it made significant changes in the senior management of the utilities business to address the problems encountered; and that the number of staff assigned to the utilities software product had more than tripled.

that the absence of revenues was due to the absence of demand for the product as opposed to the company's withdrawal of its sales efforts is immaterial. Reasonable investors know that it is common and natural to put a spin on why sales are declining. SCT's "spin" on this adverse information was that they were not pushing the product because they did not want to give customers a "lousy" product. While to another customer, this may be misleading, to a purchaser of stock, the objective facts have been disclosed: the product is defective and do not anticipate revenues from the sale of this product in the immediate future. The reason given is immaterial. If the company discloses that sales are declining and that a defect in the product is the reason for this decline, that is all the securities laws require.

Further, the representation that the utilities business was strong is not misleading as a matter of law. The company, in the same conference call disclosed that they were taking the product off the market and that it was defective.

Finally, the plaintiffs allege that the defendants' statement that sales have "slowed" is materially misleading because, sales had, in fact, "stopped."[35] However, this argument ignores that fact

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[35] "As the defendants admitted publicly after the class period in an early January 1996 conference call with investment professionals, the defects of the company's software for the utilities market were so serious and extensive that none of the company's utilities customers would recommend Systems' utilities software to potential purchasers. As a result, because software purchases by utilities are based on recommendations of customers who have installed the software and are using it . . . the company was unable to sell its utilities software to any customers for approximately a year commencing at approximately

that the absence of sales today does not preclude sales tomorrow and fails to recognize that the reasonable investor looks at business as an ongoing process. In the short term, customer orders have ceased. In the long view, sales have merely "slowed". Only from hindsight could one determine that the sales have been absent for such a protracted period of time that they should be characterized as having stopped. The fact that from hindsight sales stopped for a year does not require one to say in the beginning that sales have stopped. SCT was not required to berate itself or resort to a level of self-criticism that would have been harmful to its shareholders' interests. See Data Probe Acquisition Corp. v. Datalab, Inc., 722 F.2d 1, 5-6 (2d Cir. 1983) (disclosure requirements are limited to a statement of objective factual matters and do not impose a "right of confession"). SCT was not required to characterize as permanent, what appeared to be a temporary cessation of customer orders caused by a correctable defect in a product-even if they believed, as plaintiffs claim, that a "redesign" of the product was necessary. As long as they did not know that the defect in the software was fatal to the

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the beginning of the class period." ¶ 33; Supra, Note 10; See also, Pl's. Mem. in Opp. to Def. Mot. to Dism. at 24 ("defendants belatedly admitted, in January 1996, that their inability to procure favorable recommendations of their utilities software from any existing customers had left SCT unable to sell its utilities software to any customers since about the beginning of the class period . . . and as a result of reported malfunctions of the utilities software at customers' sites, defendants knew or recklessly disregarded the fact that the defects were so serious that virtually complete redesign of the software was necessary.").

product, they were entitled to assume business would pick up when they fix the problem. Courts have uniformly rejected such attempts to plead fraud by hindsight, acknowledging that a plaintiff does not state a claim for securities fraud merely because a company discloses, after the fact, that its performance failed to meet expectations. See In re Goodyear Tire & Rubber Co. Sec. Lit., 1993 WL 130381 at *2 (E.D. Pa. Apr. 1993); DiLeo v. Ernst & Young, 901 F.2d 624, 626 (7th Cir.) cert. denied, 498 U.S. 941 (1990) (plaintiff fails to state a claim for fraud where he alleges nothing more than a claim that disclosures made in later reports should have been made in earlier reports); Pommer v. Medtest Corp, 961 F.2d 620, 623 (7th Cir. 1992)("the securities laws approach matters from an ex ante perspective"). Plaintiffs do not allege that the defendants knew that the defect was permanent or that they knew in the beginning of the class period that sales would stop for the entire year. SCT's disclosures relied on by plaintiff suggest otherwise. See DX-A ("Now this is not rocket science, it's, you know, human beings can do this work, so it'll get done and hopefully there will be a release this quarter of a much cleaner version of the software and we get back on track again, but we've been working on that one now for about 6 or 7 months, maybe even a little bit longer, a problem on that and I've sort of alerted you to the problem."); see also, Reply Mem in Supp of Def's Mot. at 9 (In a January 4, 1996 conference call, SCT stated, "But some of the customers, I think, are understanding and are good references now. Some just don't want to be references until they're fixed up, and

up and running.") There is a delicate balance between disclosure and an insiders' duty to protect the corporation and its' shareholders' investment. Indeed, characterizing sales as having "ceased" when the company did not know with reasonable certainty that the situation was permanent may itself have been misleading as well as harmful to investors.

Accordingly, I conclude that, a reasonable investor would understand that SCT would experience a short term drop in revenue growth in the utilities business as a result of the slowing of sales, whether the result of a strategically implemented voluntary decision or the result of customer dissatisfaction, and an accompanying increase in costs as SCT attempted to evaluate and resolve the problems. see In re Numerex Corp. Sec. Litig., 913 F.Supp. 391, 400 (E.D. Pa. 1996) ("the federal securities laws were intended to protect the average, reasonable investor, not the most unworldly naif. They do not require a company to state the obvious."); see also, Wieglos, 892 F.2d at 512, 519 (a company need not disclose what are known facts of life, nor does a company need to disclose the inevitable operation of Murphy's Law or the Peter Principle even though they have a substantial effect on business). SCT was not required to characterize the difficulties it was experiencing in the utilities software with pejorative descriptions, nor was it required to announce all possible adverse inferences. Data Probe Acquisition Corp. v. Datalab, Inc., 722 F.2d 1, 5-6 (2d Cir. 1983) cert. denied, 465 U.S. 1052 (1984). Moreover, as noted, a reasonable shareholder would understand from

the statement "sales have slowed" that there are problems with sales and that revenues are down.

Rule 9(b)

I will dismiss plaintiffs' allegation regarding SCT's statement that sales had "slowed" for an independant reason. Plaintiffs fail to adeqately plead scienter with specificity as required by Rule 9(b).[36] In order to establish scienter, plaintiffs "must allege facts that give rise to a 'strong' inference that SCT

[36] Although a complaint may state a claim for securities fraud under § 10(b) of the Securities Exchange Act of 1934 under a general notice pleading, the complaint fails if it does not satisfy the particularity standard of Rule 9(b). Rule 9(b) provides that "malice, intent, knowledge, and other condition of mind of a person may be averred generally." Until recently, the meaning of this sentence has been the source of considerable debate. The Third Circuit has recently held that a complaint alleging securities fraud must allege specific facts that give rise to a "strong inference" that the defendant possessed the requisite fraudulent intent. In re Burlington Coat Factory, 114 F.3d 1410, 1418 (3d Cir. 1997). The requisite strong inference of fraud may be established either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness. Id.

Other circuits, most notably the Ninth Circuit, do not interpret Rule 9(b) as requiring that the complaint furnish a detailed exegesis of how the defendants came by the knowledge of those facts which belie their statements. The Third Circuit rejected the approach taken by the Ninth Circuit in In re Glenfed, Inc. Sec. Litig., 42 F.3d 1541 (9th Cir. 1994)(in banc) and explicitly adopted the approach taken by the Second Circuit. For examples of the Second Circuit's approach see Acito v. IMCERA Group, Inc., 47 F.3d 47, 53 (2d Cir. 1995); Suna v. Bailey Corp., 107 F.3d 64, 68; Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068.

The purpose of this pleading requirement is three-fold: to provide a defendant with fair notice of the plaintiff's claim, to protect defendants from harm to their goodwill or reputation, and to reduce the number of strike suits. Burlington, at 1418; In re Valuevision Intern. Inc. Sec. Litig., 896 F.Supp. 434 (E.D. Pa. 1995).

knew or was reckless in not knowing that SCT's statements were misleading. In re Burlington 114 F.3d 1410, 1418 (3d Cir. 1997). Plaintiffs must either (1) identify circumstances indicating conscious or reckless behavior by the defendants, or (2) allege facts showing both a motive for committing the fraud and a clear opportunity to do so. Id. at 19-20 (citing, Acito v. IMCERA Group, Inc. 47 F.3d 47, 53 (2d Cir. 1995)). Rule 9b has also been interpreted by the courts to require that the plaintiff allege "the time and place, the persons involved, the statements made, and an explanation of why and how the statements were false at the time they were made." In re Glenfed, Inc. Sec. Lit., 42 F.3d 1547-48, n.7 and 1549 (9th Cir. 1994)); Dileo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir.), cert. denied, 498 U.S. 941 (1990). Thus, under Rule 9(b), plaintiffs may not simply point to a bad result and allege fraud, Glenfed, 42 F.3d at 1548. Rather, they must show how the earlier statements were misleading at the time they were made. Id. This can be done most directly by alleging inconsistent contemporaneous statements which were made by defendants or inconsistent contemporaneous information which was made available to the defendants.[37] Glenfed, 42 F.3d at 1548-49; Fecht, 70 F.3d at 1082 (alleged statements conflict with contemporaneously existing facts that were later revealed to the market). This particularity

[37] The existence of such statements may also have the incidental effect of supporting an inference of scienter.

requirement has been rigorously applied in securities fraud cases.[38] Despite Rule 9(b)'s stringent requirements, however, the Third Circuit has observed that "the courts should be `sensitive' to the fact that the application of the Rule prior to discovery `may permit sophisticated defrauders to successfully conceal the details of their fraud.'" In re Burlington Coat Factory, 114 F.3d 1410, 1418 (3d Cir. 1997)(citations omitted). Accordingly, the normally rigorous particularity rule has been relaxed somewhat where the factual information is peculiarly within the defendant's knowledge or control. Shapiro v. UJB Financial Corp., 964 F.2d 272, 285 (3d Cir. 1992); Craftmatic Sec. Lit. v. Kraftsow, 890 F.2d 628, 645 (3d Cir. 1989). But even under a relaxed application of Rule 9(b), boilerplate and conclusory allegations will not suffice; a plaintiff must still provide "a statement of the facts upon which the allegations are based." Craftmatic, 890 F.2d at 645. Plaintiffs must accompany their legal theory with factual allegations that make their theoretically viable claim plausible. Burlington, 114 F.3d at 1418.

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[38] For example, where plaintiffs allege that defendants distorted certain data disclosed to the public by using unreasonable accounting practices, we have required plaintiffs to state what the unreasonable practices were and how they distorted the disclosed data. In Re Burlington Coat Factory, 114 F.3d 1410, 1417-18 (citing, Shapiro v. UJB Fin. Corp., 964 F.2d 272, 284-85 (3d Cir. 1992); In re Valuevison International Securities Lit., 896 f.supp 434, 446 (E.D. Pa. 1995)("For instance, if a corporation's offering documents state that it has $100 million in assets, a plaintiff can assert this statement is false by pointing to facts suggesting that the corporation had fewer assets. In such a case, the accuracy of the challenged statement can be measured against an external fact.")

Plaintiffs attempt to plead scienter by asserting the conclusory allegation that SCT "belatedly admitted" after the class period that utilities customers would not recommend the product and that sales had ceased at the time the statements were made.[39] In this case, plaintiffs have not furnished the court with any statement in the complaint or in their reply to defendants' motion which could reasonably be read as admissions that SCT knew, at the beginning of the class period, that customers' failure to recommend the product would lead to a permanent cessation of sales. One may surmise that the complaint's failure to provide any supportive, concrete allegations is traceable, at least in part, to the fact that detailed information on such matters would tend to be within the exclusive purview of management-i.e., the defendants.[40]

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[39] Plaintiffs rely on a "belated admission" in January 1996, three months after the close of the class period, and in the Form 10-K for the year ending September 30, 1996, published one year after the close of the class period. Plaintiffs allege that this statement reveals that SCT's inability to procure favorable recommendations of their utilities software from any existing customers had left SCT unable to sell its utilities software to any customers since the beginning of the class period without quoting any particular statement. SAC ¶ 33; DX-A at 6. Plaintiffs claim that their pleading is sufficient. Glenfed, 42 F.3d 1541, 1549 & n.9 (9th Cir. 1994) (Rule 9(b) standard most easily satisfied with statements along the lines of "'I knew it all along.'"

[40] "A flexible application" of the Rule is the touchstone. In re Craftmatic Sec. Lit. v. Kraftsow, 890 F.2d 628, 646 (3d Cir. 1989) (leading decision interpreting rule 9b in securities context). The Third Circuit has cautioned against "too narrow an approach [which] fails to take account of the general simplicity and flexibility contemplated by the rules." Id. at 645. It recognizes that there are sophisticated defrauders who may escape justice if the courts apply too strict a requirement of particularity. Id. The court reminds us of the reality that "in cases of corporate fraud, plaintiffs cannot be expected to have

However, under Shapiro v. UJB Financial Corp., in order to avoid dismissal, plaintiffs alleged securities fraud must "delineate at least the nature and scope of plaintiff's effort to obtain, before filing the complaint, the information needed to plead with particularity." 964 F.2d 272, 285 (3d Cir. 1992); McCarthy v. C-Cor Electronics, Inc., 909 F.Supp. 970, 978 (E.D. Pa. 1995). The complaint provides no information of this type. As the Shapiro court explains, "[t]his requirement is intended to ensure that plaintiffs thoroughly investigate all possible sources of information including but not limited to all publically available relevant information, before filing a complaint." Id.

Plaintiffs have also endeavored to plead scienter by alleging facts that point towards motive and opportunity to commit fraud. Plaintiffs have alleged that the individual defendants were top officers of SCT and hence had the opportunity to manipulate SCT's disclosures to the public. In addition, plaintiffs have alleged that defendants artificially inflated the price of SCT stock so as to enable the individual defendants, top officers of SCT, to sell their stock holdings at these inflated prices. In support of this theory, plaintiffs' second complaint provides this court with the names of the insiders who sold stock, the quantities of the stock

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personal knowledge of the details of corporate internal affairs." Id. Nonetheless, Rule 9(b) is not a nullity. Pleaders must allege that necessary information lies within defendant's control and must set forth statements of facts upon which the allegations are based." Id. In other words, plaintiffs must state facts indicating why the charges against defendants are not baseless and why additional information lies exclusively within defendant's control." Id. at 646.

sold, the prices at which the sales occurred, and the dates of the sales.[41] What these allegations boil down to is that two officers of SCT made a profit of approximately $80,000 as a result of the artificial inflation of the price of SCT's stock. Plaintiffs have not provided this court with the total stock holdings of the two defendants who are alleged to have traded on nonpublic information nor have they provided us with information as to whether such trades were normal or routine for these defendants. Furthermore, we have no information as to whether the profits made were substantial enough in relation to the compensation levels for either of the individual defendants so as to produce a suspicion that they might have had an incentive to commit fraud. Such allegations are inadequate to produce a "strong" inference of "fraudulent intent." In re Burlington, 114 F.3d at 1422-24; see also, San Leandro, 75 F.3d at 814 (the fact that defendant did not sell all of his stock and retained a large holding in the company makes clear that the trading was not "unusual" and thus, does not permit an inference of scienter). Had we not dismissed on Rule 12(b)(6) grounds, we would conclude, therefore, that dismissal of this claim on Rule 9(b) grounds is proper.

(2) FOURTH QUARTER RESULTS

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[41] The transactions which took place in July of the third quarter of the relevant fiscal year are as follows.

Insider	Sale date	No. Shares Sold	Price	Total Proceeds
Michael Emmi	7/26/95	10,000	$26.38	$263,800
Eric Haskell	7/27/95	10,000	$26.63	$266,300

SAC. at ¶ 56.

Plaintiffs allege that SCT and the individual defendants failed to disclose the likelihood that SCT's income and earnings per share ("EPS") for the fourth quarter of fiscal year 1995 would decline from SCT's reported income and EPS for (1) the fourth quarter of fiscal year 1994 and (2) the third quarter of fiscal year 1995. Specifically, plaintiffs allege that during a July 17, 1995 conference call "in which many investment professionals participated," "defendants Emmi and Haskell stated that . . . (d) the company expected earnings of almost $.34 per share, up from $.27 per share in the fourth quarter of 1994, for the fourth quarter of its 1995 fiscal year ending September 30 1995." ¶¶ 43-44.[42] In order to establish liability under this theory, plaintiffs

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[42] I will assume that plaintiff's will point to an explicit earnings projection of "almost $.34 per share for the fourth quarter of fiscal 1995" made during the July, 1995 conference call. I merely note that upon examination of the transcript of this conference call, this court cannot locate such an explicit earnings projection.

This court has located the following statement by defendants regarding fourth quarter results. SCT reported that third quarter earnings per share were $.27 cents per share for the third quarter of 1995 and noted that "[their] second half is traditionally the strongest part of the year . . . principally due to license fees." DX-A at p.1. They stated further that, "all in all, we think the business outlook for the remainder of the year remains strong . . . Our current growth rate of 20% with any kind of luck we can end the year, for the whole year, with a 23% growth. That's to say we are expecting a strong fourth quarter and you're always are a little nervous when you say that because, after all, it is largely driven by license fees and you never know 'til it's over exactly how they come out. But with any kind of luck we should have a good fourth quarter and meet everyone's expectations for the year." DX-A at 3-4.

Even if plaintiffs could point to a specific express earnings forecast of $.34 for the fourth quarter not contained in the transcript of the July conference call which was submitted by the defendants, this projection is immaterial. Clearly, the overall impression of any statement about fourth quarter results

must sufficiently allege that this statement was misleading. A forecast is an actionable misrepresentation if the speaker does not genuinely and reasonably believe it at the time it is made.[43] see, Burlington, 114 F.3d 1410, 1427 (3d Cir. 1997) ("If a company voluntarily chooses to disclose a forecast or projection, that disclosure is susceptible to attack on the ground that it was issued without a reasonable basis.").

Plaintiffs bear the burden of "pleading factual allegations, not hypotheticals, sufficient to reasonably allow the inference" that the forecast was made with either (1) an inadequate consideration of the available data or (2) the use of unsound forecasting methodology. Id. at 1429; see also, Glassman v. Computer Vision Corp., 90 F.3d 617, 626 (1st Cir. 1996) (rejecting plaintiffs' earnings projection claim on Rule 12(b)(6) grounds alone, albeit in the context of the plaintiffs having had the benefit of discovery); Virginia Bankshares, Inc. v. Sandberg, 501

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is accompanied by specific cautionary language. The company explicitly states that results for the fourth quarter is contingent on license fees.

[43] The Third Circuit has held that an ordinary, run-of-the mill earnings projection contains no more than the implicit representation that the forecasts were made reasonably and in good faith and disclosure of a specific earnings forecast does not contain the implication that the forecast will continue to hold good even as circumstances change. They do not contain an implicit representation that the company will update the investing public with all material information that relates to that forecast. Burlington, at 1431. Accordingly, SCT had no duty to update this earnings projection in light of events that occurred or became known to SCT subsequent to the making of that projection.

U.S. 1092-94 (describing the type of hard contemporaneous facts that could show an opinion as to the fairness of a suggested price to have been unreasonable when made); Shapiro v. UJB Fin. Corp., 964 F.2d 272, 284-85 (3d Cir. 1992) (in attacking a firm's accounting practices with a claim that those practices resulted in the disclosure of misleading data, plaintiffs must (a) identify what those practices are and (b) specify how they were departed from). In this case, plaintiffs have alleged that this forecast was issued without a good faith belief in its truth or lacked a reasonable basis because SCT knew that the utilities business segment and Adage, the manufacturing and distribution business segment, were performing poorly. They allege that (1) sales of the existing utilities software had halted; and (2) Adage was experiencing losses. SAC ¶¶ 46; 31-33, 37-38, 41-42. Defendants claim that the allegedly omitted information was disclosed.[44] Knowledge by SCT of this information does not deprive this forecast of a reasonable basis. It is entirely possible that SCT and its officers expected revenues derived from other markets to make up for any increase in expenses resulting from difficulties with the

[44] As the Third Circuit has recently concluded, there is no duty to update an "ordinary run of the mill earnings forecast" on account of a subsequent event because disclosure of a specific earnings forecast does not contain the implication that the forecast will continue to hold good even as circumstances change. Burlington, 114 F.3d at 1433. Thus, the plaintiff must allege that the events or information alleged to deprive the forecast of a reasonable basis existed and were known or recklessly disregarded by defendants at the time the forecast was made. Subsequent events do not trigger a duty to update an ordinary run-of-the-mill forecast.

new product for the utilities market or from the acquisition of Adage. SCT's other business segments were performing strongly. During the July 17 conference call, SCT revealed that "our strongest area of growth, both revenues and earnings, was higher education;" "[L]ocal government also did well. . . this is the second quarter in a row that remained positive in terms of earnings and growth." DX-A at 2. Moreover, historical performance itself can provide a reasonable basis for predictions of future growth. In re Craftmatic, 890 F.2d at 642 n.19 (Management projections of profit and growth can have a reasonable basis if there is a history of profitable operations.). In 1995, approximately 59% of the Company's revenues were derived from the higher education market, approximately 22% were derived from the local government market, approximately 16% were derived from the utility market, and approximately 3% were derived from other markets. DX-H at 4. In each quarter of the 1994 fiscal year ending September 30, 1994, SCT's net income and earnings per share increased over the prior quarters and in each of the first three quarters of 1995, earnings per share increased over prior quarters.[45] Id. ¶ 27.

Furthermore, small differences between stated earnings goals

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[45]

	12/31/93	3/31/94	6/30/94	9/30/94
Net Income	$ 1,967	$ 2,822	$ 2,906	$ 3,951
Earnings Per Share	$.15	$ .20	$ .21	$ .27

	12/31/94	3/31/95	6/30/95
Earnings Per Share	.21	.23	.27

DX-H; SAC ¶57,30.

Following a July press release and conference call, an analyst issued a report stating, "this was the third sequential strong quarter for [SCT]. SAC §39.

and internal estimates do not alone deprive statements of a reasonable basis where the company emphasized that a certain factor could affect fiscal earnings. Roots Partnership v. Lands End, Inc., 965 F.2d 1411, 1418 (7th Cir. 1992) (plaintiffs only entitled to an inference that the defendants' statements implied that its earnings goals of 10% were within the company's reach). In this respect, SCT disclosed in the July 17 conference call that although license fees from all of SCT's businesses are "the principal reason that the second half is traditionally the strongest part of the year," they "are always uncertain". DX-A at 1; see also, DX-A at 3-4 ("That says that we're expecting a strong fourth quarter and you always are a little nervous when you say that because after all it is largely driven by license fees and you never know 'til its over exactly how they come out. But with any kind of luck we should have a good fourth quarter". . ."So with all of that happening we would look for the fourth quarter to be a very strong quarter in terms of add to the back log and to set up the first quarter growth") Id. SCT's Third quarter Form 10-Q file August 10, 1995 stated further that, "numerous factors could affect SCT future operating results, including general economic conditions . . . , SAC ¶46, and "operating results for the three and nine month periods ended June 30, 1995 are not necessarily indicative of the results that may be expected for the year ending September 30, 1995." ¶47.

> "Numerous factors could affect SCT's future operating results, including general economic conditions, continued market acceptance of SCT's products, and competitive

> pressures. Future revenue growth and operating results are in part dependant upon accelerated license fee revenue and related services growth from SCT's international operations. SCT's ability to sustain growth depends in part on the timely development or acquisition of successful new and updated products. SCT is investing in the development of new products and in improvements to existing products. The company has new products in development for the government and utilities markets." The costs of such products have been capitalized. SAC ¶ 33-36, ¶ 46.

They also allege that SCT's knowledge that (1) expenses were sharply increasing due to the "addition of hundreds of employees" and the "cost associated with the extensive known defects of [SCT's] utilities software;" and that (2) product development costs were increasingly being expensed rather than capitalized deprives this forecast of a reasonable basis. However, as noted earlier, this information was disclosed by SCT and cannot deprive the earnings projection of a reasonable basis.

(3) **ADAGE** [46]

Next, plaintiffs claim that certain statements made during the July 17, 1995 conference call imply that Adage would not be a drag on the company's earnings (i.e., would not be unprofitable) when,

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[46] In determining defendants' motion to dismiss the first amended complaint, this court observed, "the court fails to see how a reasonable investor would take away from these passages that SCT's purchase would spawn near-term financial benefits. If anything, these disclosures signal the opposite effect." The press releases reiterate that Adage was a young company whose software was newly-developed for an untapped market into which SCT was entering and seeking to expand. SCT did not boast of Adages's established customer base, but named only one existing Adage client . . . SCT also acknowledge that it would continue to enhance the Adage software. Wallace, at 5, 14. In the SAC, the plaintiffs have quoted a statement from a July conference call that was not reviewed by us in deciding defendants' first motion to dismiss.

in fact, they expected Adage to suffer a loss in the fourth quarter of fiscal 1995.[47] ¶¶ 43-44. During the call, defendants Emmi and Haskell were asked the following question:

> "I just wanted to check with hiring 10 additional sales people and talking about a few management changes going on here. Do we have to worry about any near-term cost dislocations [within Adage] with the costs being up and we all know it's probably going to take a little time to get the first orders into the bottom line. Any impact I should be worried about there?"

DX-A at 5.

In response, defendants stated,

> Bob, we don't think so. Of course, you know, when you hire these guys you do pick up their costs. But we hired very experienced people who came into the business . . . so our current forecast is that you should not have to worry about the cost side of these moves in the fourth quarter. There will be some increased costs, but they'll be offset by increased revenues."

DX-A at p.5.

> Q. So Adage can have a positive effect almost out of the chute here?"
>
> A. Emmi: "That's what we're hoping."[48] Id.

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[47] The court notes, in passing, that in framing their complaint, plaintiffs have not quoted a particular statement by SCT or its officers about Adage. Rather, they attribute to SCT or its officers statements that are, in fact, no more than the conclusions reached by the plaintiffs. Plaintiffs' response to defendants' motion reveals the actual wording of the statement that forms the basis of their claim.

[48] Our examination of the transcript of the July 17, 1995 conference call reveals that the defendants made the following statements regarding the newly-acquired Adage subsidiary:

> Q:" Will you talk a little about the Adage road map I guess you have for that business, what you think will happen with head counts there, and what kind of contribution you think it will make in fiscal 1996
>
> A:"Unfortunately, I cannot be as forthcoming yet as I'd like to be. And it's not that we're holding back, we just don't know yet. We're working on the operating plan for Adage for next year as we speak. So

Plaintiffs contend that these forward-looking statements lacked a reasonable basis when they were made because by mid-July, SCT "had clear indications of Adage's finances for the fourth quarter" that amounted to knowledge that Adage would suffer a "material loss" in the fourth quarter ending September 30, 1995. Pl's. Resp. at 13. Specifically, plaintiffs claim that SCT knew that (a) the business was characterized by long lead times for order placement by its customers so that unless the selling commenced months in advance of the end of a quarter, it was highly improbable an order would be placed during a quarter; (b) by July 17, 1995, the company had incurred costs for adding new employees for the Adage business; and (c) the company knew, from actual and planned expenses, that Adage would suffer a material loss in the fourth quarter ending September 30, 1995. SAC ¶¶ 43(c)-44, 37.

I conclude that this prediction does not constitute a material

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> that's work in process and I'd hate like heck to start to discuss something that we haven't got a fix on as yet, because that could be misleading to you guys. So give us a quarter, and next quarter I can be much more forthcoming because we'll have at least better answers, better points of view. DX-A at 7.
>
> Q: My question is...on the revenue projections possibly for Adage, if it was $5 million when you guys bought it, I've heard estimates as high as $100 million in the next few years and I wondered if you had any feel at all, although you've kind of said already it's a little early, as to whether that's attainable for you."
>
> A:"I guess Eric and myself and Dave would be dissappointed if we couldn't grow this business at 100% kind of growth rate over a five year period." Id. at 9.

misrepresentation as a matter of law because it is accompanied by sufficient cautionary language. The statement, itself, is couched in cautionary language which relates to the reliability of the projection.[49] Accordingly, this statement would not be read by the reasonable investor as the guarantee it appears to be when taken out of context. In addition, SCT made other tempering statements during the July conference call. For example, SCT cautioned that (1) revenues were "dependant on license fees;" (2) it would "take a little time to get the first orders into the bottom line"; (3) they "just d[id]n't know yet;" (4) "did not yet have enough numbers to crank through;" (5) did not yet have a "fix" on Adage's potential impact on Company performance and were "working on the operating plan for Adage for next year as we speak;" (6) "when you hire these guys you do pick up their costs;" and (7) requested that investors "give [them] a quarter, and next quarter [they could] be much more forthcoming because [they]'ll have at least better answers, better points of view." DX-A at 5-9.

In other statements made before and during the class period, SCT also disclosed that the Adage acquisition was the first step in entering a new market and that there would be costs associated with launching this new area of business.[50] A reasonable investor

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[49] For example, "we don't think" you will have to worry about any impact from Adage in the fourth quarter; our "current" forecast is that you "should" not have to worry about costs in the fourth quarter.

[50] Plaintiffs quote my decision in Wallace for the proposition that "the company's disclosures concerning Adage acknowledged that: 1) Adage was a young entrepreneurial company

understands, without being told explicitly, that there are costs and risks involved in attempting to enter and to compete in a new market with new products. It is generally known that adding new employees is an increased cost. There is no general duty to disclose general economic conditions because federal securities laws do not compel disclosure of the obvious. In re Trump Casino, 7 F.3d 357, 377 (3rd Cir. 1993); Lewis v. Chrysler Corp, 949 F.2d 644, 651 (3d Cir. 1991) (there is no actionable omission of material fact where a company declines to tell the investing public that which any reasonable investor would already know); Krim v. Banctexas Group, 989 F.2d 1435, 1446 (5th Cir. 1993) (compliance with securities laws requires issuers to disclose material firm-specific information regarding predictions but information concerning general economic facts and conditions is presumed to be known by investors and analysts). I conclude that this statement is not misleading as a matter of law.

Duty to disclose under Item 303(b)

It is well established that silence is not misleading absent a duty to disclose. Basic, 485 U.S. at 239 n.17. Under existing

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with a newly developed product; 2) the market for Adage was untapped; 3) the acquisition of Adage Systems represented a new product development direction for SCT; 4) Adage systems did not have an installed customer base; 5) in July 1995, SCT hired 10 seasoned professionals from Anderson Consulting to market Adage Systems; 6) SCT planned to continue to enhance the Adage Systems software; 7) there were multiple proposals in the Adage Systems pipeline that had yet to be answered; and 8) when structuring the acquisition, Adage and SCT agreed that SCT might be required to pay additional consideration to Adage based on Adage's performance and the performance of SCT stock over 5 years. Wallace, 1996 WL 195382 at *5-6.

law, where purchasers or sellers of stock have been able to identify a specific false representation of material fact or omission that makes a disclosed statement materially misleading, a private right of actions lies under § 10(b) and Rule 10b-5. In re Burlington Coat Factory Sec. Lit., Civil Action No. 96-5187, Slip. Op. at 13 n. 7, (3d Cir. June 10, 1997); Hayes v. Gross, 982 F.2d 104, 106 (3d Cir. 1992). Plaintiffs, however, did not merely assert that SCT made affirmative misstatements in and omissions from disclosed statements. They also alleged that SCT failed to comply with affirmative disclosure requirements under "Item 303 of Regulation S-K." 17 C.F.R. §229.303(a)(1)-(3) and (b). Under Item 303(a)(3)(ii), governing reporting for full fiscal years, SCT had a duty to

> "describe any known trends or uncertainties that it reasonably expects to have a material. . . impact on net sales or revenues or income from continuing operations. If the registrant knows of events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in the relationship shall be disclosed. Instruction 3 to 303(a) notes that the company must disclose "material events and uncertainties known to management that would . . . (3) cause reported financial information not to be indicative of future operating results." Item 303(b), governing interim reporting, requires that the registrant discuss "any material changes in financial condition in those items specifically listed in paragraph (a). 17 C.F.R. §229.303(b).

In the amended complaint and again in the SAC, plaintiffs contend that the defendants violated their duty to disclose under Rule 10b-5 by failing to disclose information in Form 10-Q filed on August 10, 1995 in violation of Item 303 of SEC Regulation S-K, 17

C.F.R. 229.303(a)(1)-(3). The allegedly omitted information included the fact that: Product development costs were increasingly being expensed rather than capitalized and that by mid-July, SCT had "deliberately incurred and planned increases" in: (1) research and product development costs; (2) selling, general, and administrative costs; and (3) employee costs that raised SCT's expense levels by more than $3 million in the fiscal 1995 fourth quarter." Am. Compl. ¶ 41, 45; SAC ¶ 38. It is an open issue whether violations of Item 303 create an independant cause of action for private plaintiffs. In re Burlington Coat Factory Sec. Lit., 114 F.3d 1410, 1419, n.7 (3d Cir. 1997)(declining to reach the issue). See, Feldman v. Motorola, Civ.A.No. 90-C-5887, 1993 WL 497228, at *9 (N.D. Ill. Oct. 14, 1993) ("A demonstration of a violation of the disclosure requirements of Item 303 does not inevitably lead to the conclusion that such disclosure would be required under Rule 10b-5."); In re Canandaigua Sec. Lit., 944 F. Supp. 1202, 1209 n.4 (S.D.N.Y. 1996)("[It is] far from certain that the requirement that there be a duty to disclose under Rule 10b-5 may by satisfied by importing the disclosure duties from S-K 303"); Kriendler v. Chemical Waste Management, Inc. 877 F.Supp. 1140, 1157 (N.D.Ill 1995) (adopting the Ninth Circuit holding in "declining to hold that a violation of S-K 303 may be imported as a surrogate for . . . [materiality] analysis under §10(b) and Rule 10b-5"). This court has already held by order dated April 19, 1996, that plaintiffs have sufficiently alleged that defendants had a duty to disclose this information to the investing public created by Item

303 and that the information was not so obviously unimportant so as to allow the court to deem it immaterial as a matter of law. Wallace v. Systems Computer Technology, et.al., at 23-24 (E.D. Pa. 1996)(citing, Craftmatic, 890 F.2d at 641 n.17 (noting that "disclosures mandated by law are presumably material"); 17 C.F.R. § 220.303(a)(3)(ii); 17 C.F.R. § 220.303(a) Instruction 3. We allowed the claim to proceed while also recognizing that a violation of the disclosure requirements of Item 303(b) does not inevitably lead to the conclusion that such disclosure would be required under Rule 10b-5. Accordingly, I will allow this claim to proceed and it will not be discussed further. I will also allow to proceed plaintiffs claim that defendants' violated Item 303(b) for failing to disclose "actual and planned expenses" and "visible revenues" for Adage in its Form 10-Q for the third quarter. SAC ¶ 37.

In addition, plaintiffs allege that defendants' failure to disclose facts concerning the extensive defects of its utilities software and the likely future effects thereof in SCT's Form 10-Q for the third quarter consitutes an additional violation of Item 303(b). SAC at ¶¶ 35-36, 46. SAC ¶ 46-47. However, Instruction 7 to Item 303 draws a distinction between "forward looking information" which need not be disclosed, and "presently known data which will impact upon future operating results, such as known future increases in costs of labor or materials." 17 C.F.R. 229.303(a)(3)(ii). Because plaintiffs have not established that SCT could have known with the degree of assurance implied by the

instruction that the software defects in question would have a material adverse impact upon future operating results, I dismiss this claim.

§ 20(b) Control Person Liability

SCT does not contend that plaintiffs have failed to state a claim for control person liability under § 20 against the individual defendants. Rather, SCT argues only that this claim should be dismissed because, "absent an underlying violation of the securities laws, there can be no violation of section 20."

However, as set forth in the preceding paragraphs, plaintiff's have stated a viable claim for violation of §10b and Rule 10b-5. Accordingly, this claim will survive the motion.

Supplemental Jurisdiction - Negligent Misrepresentation

Plaintiffs, public investors, allege that defendants breached a duty of care to plaintiffs by negligently misrepresenting facts in their public statements.[51] This court has supplemental

[51] Specifically, plaintiffs allege that "plaintiff and other class members relied upon the material misrepresentations and/or the integrity of the market in trading in [SCT] stock at the prices paid. Such reliance and the fact that defendants' negligence would result in damages to the Class were reasonably foreseeable by defendants." SAC at ¶ 70. The complaint alleged further that,

> "[T]he direct and proximate cause of the misrepresentations and omissions was the negligence and carelessness of defendants. At the time of the material misrepresentations, plaintiff and the class members were ignorant of their falsity and misleading nature and believed theme to be true. In reliance on said misrepresentation, and or upon the superior knowledge and expertise of defendants and or the integrity of the market and in ignorance of the true facts, plaintiff and other class members were induced to and did trade in [SCT] stock at inflated prices. Had plaintiff's known the true fact, they would not have taken such action. As a direct

jurisdiction over plaintiff's claim for negligent misrepresentation. Eisenburg, 766 F.2d at 778. Because I find that plaintiffs have stated a claim for violation of federal securities law, I will not decline to exercise supplemental jurisdiction over plaintiff's claim for negligent misrepresentation.

The elements of negligent misrepresentation under Pennsylvania law, which the parties agree governs this case, are set forth in the Restatement (Second) of Torts, §552.[52] Defendants argue that the

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and proximate result of the defendants; careless and negligent conduct in violation of duties owed to plaintiff and other class members, plaintiff and each class member suffered damages." SAC at ¶¶ 69-73.

The complaint also alleges that "the investment community, and, in turn, investors, directly and indirectly relied upon the information disseminated in these conference calls in making their purchase of the company's securities. SAC at ¶ 21.

[52] The Restatement (Second) of Torts provides in relevant part:

> (1) One who, in the course of business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
>
> (2) The liability in subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or know that the recipient so intends or in a substantially similar transaction.
>
> (3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the

SAC does does not state a cause of action for negligent misrepresentation under § 552 because Pennsylvania law restricts liability for negligent misrepresentation to a "person or limited group of persons" and that "investors" cannot form such a "limited group." Other courts examining this issue have divided on whether public investors constitute a "limited group of persons for whose benefit and guidance [defendants] intend to supply the information." Compare In Re Chambers Development Secs. Litig., 848 F.Supp. 602, 626 (W.D. Pa. 1994)(allowing a cause of action to proceed) and In re Atlantic Financial Fed Sec. Litig., 1990 WL 171191, at *2 (E.D. Pa. 1990)(same) with Pearl v. Geriatric & Medical Centers, Inc. et al., 1995 WL 243675 (E.D. Pa. 1995) (dismissing negligent misrepresentation claim). I conclude that public disclosures made pursuant to the federal securities laws are made to an undefined and potentially unlimited class of investors and not to "a limited group." Indeed, the limited group requirement would be meaningless if any member of public who might choose to invest in company's common stock could qualify as part of protected class. See also In re Westinghouse, 832 F.Supp. 948, 988 (W.D. Pa. 1993), aff'd without opinion, 92 F.3d 1175 (1996) (holding that class of securities purchasers do not qualify as "limited group" under the Restatement reasoning that "where a

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duty is created, in any of the transactions in which it is intended to protect them.

Thus, plaintiffs must prove: (1) material false information; (2) justifiable reliance (3) causation (4) pecuniary loss; (5) negligence.

corporation does not and cannot know the identity of the recipients of its disclosures at the time of their making, liability under § 552(2) does not obtain").

I must next determine whether any exception to the "limited group" requirement applies. Restatement (2d) §552(3) creates an exception to this requirement for "one who is under a legal duty to release information to the general public." Subsection (3)'s broader scope of liability "may apply to private individuals or corporations who are required by law to file information for the benefit of the public." See Comment K to Section 552(3). Public corporations are certainly required by law to file accurate information for the benefit of the general public, but the application of Section 552(3) to alleged misrepresentations in public corporations' SEC reports would threaten such firms with the prospect of liability to an almost unlimited class of persons, i.e., all potential investors in the corporations stock. As observed in In re Westinghouse Sec. Lit., 832 F.Supp. 948, 987 (W.D. Pa. 1993), "this position requires an assumption about the Restatement drafters' view of liability that one federal district court has disapprovingly termed 'extraordinary,' In re Crazy Eddie Sec. Lit., 812 F.Supp. 338, 359 (E..D.N.Y. 1993), and that another has rejected outright. See In re Delmarva Sec.Lit., 794 F.Supp. at 1310-11."

Even if I determined that public investors constitute a "limited group of persons" or that the exception to that requirement in §552(3) would be adopted by the Pennsylvania courts,

see e.g. National Media, 1994 WL 397398, *5 (E.D. Pa. 1994), I would dismiss plaintiffs' negligent misrepresentation claim for failure to establish another element of that claim: direct reliance by plaintiffs on the alleged misinformation. The fraud on the market theory has never been adopted by a Pennsylvania court and direct reliance remains a requirement of the common law claim of negligent misrepresentation. Peil v. Speiser, 806 F.2d 1154, 1163, n.17 (3d Cir. 1986); In re Bell Atlantic Sec. Lit., 1995 WL 733381 (E.D. Pa. 1995).[53]

It is not reasonable to predict that Pennsylvania's Supreme Court, which has adopted Restatement of Torts (2d) §552(1)'s requirement that the loss be caused by a "justifiable reliance upon the information" would so weaken the causation requirement. Westinghouse, 832 F.Supp. at 988. Absent a more clear indication that Pennsylvania would adopt such an expansive view of liability

[53] The continuing validity of the Peil footnote has been questioned in this district in light of the Supreme Courts' decision in Basic v. Levinson, 485 U.S. 224 (1988). In re Healthcare Services Group, Inc. Sec. Lit., 1993 WL 54437, *5 (E.D. Pa. 1993). A few courts have allowed plaintiffs to use the fraud on the market theory to show reliance in a negligent misrepresentation claim finding the reasoning behind the application of the theory to claims under the Securities Exchange Act of 1934 to be no less persuasive in a negligent misrepresentation case concerning a securities market, especially given the language in Restatement (2d) subsection (3), which makes violators of a "public duty" liable to "any of the class of persons for whose benefit the duty is created." In re Atlantic Financial, 1990 WL 171191, at *2 (E.D. Pa. 1990)(plaintiffs not required to show direct reliance); Healthcare, 1993 WL 54437, *5 (same). But see In re Bank of Boston Corp. Sec. Lit., 762 F.Supp. 1525, 1536 (D.Mass. 1991)(not recognizing "fraud on the market" theory) and Good v. Zenith Electronics Corp., 751 F.Supp. 1320, 1323 (N.D.Ill. 1990)(same).

or that the Peil court would hold differently today, I decline to do so.

In the case at hand, plaintiffs do not allege that SCT or its officers made representations to them individually. Nor do they allege reliance on any particular representation.[54] Rather, they assert a "fraud on the market" theory claiming that the totality of SCT's alleged misrepresentations drove up the price of SCT stock, and that they relied on the integrity of the market in making their stock purchases. Accordingly, this claim for negligent misrepresentation must be dismissed.

V. Conclusion

For the foregoing reasons, Defendants' Motion is Denied in Part and Granted in Part.

[54] According to plaintiffs, "Plaintiff and other class members relied upon the material misrepresentations and/or the integrity of the market in trading in Systems common stock at the prices paid." SAC ¶ 70. Regarding misrepresentations in the conference calls, plaintiffs further allege, "the investment community, and, in turn, investors, directly and indirectly relied upon the information disseminated in these conference calls in making their purchase of the company's securities. Defendants directly and indirectly manipulated and inflated the market price of the company's securities by falsely presenting to analysts the current status and future prospects of the company by failing to disclose the true adverse information." SAC ¶ 21.